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Activity Information	
Program Name:	16th Annual Estate Planning for Professionals
Sponsor:	SECURITY NATIONAL BANK OF SIOUX CITY
Start Date:	10/15/2018
End Date:	10/15/2018
City:	South Sioux City
Class Type:	Standard(live)
Total CLE Hours Approved:	4.0
Ethics Hours Approved:	1.0
Activity Number:	307976

This approval means that time spent in continuing legal education activities incorporated in this accredited program may be credited against the continuing legal education requirement of fifteen (15) clock hours per year, established by Rules 41.3 and 42.2 of the Iowa Supreme Court.

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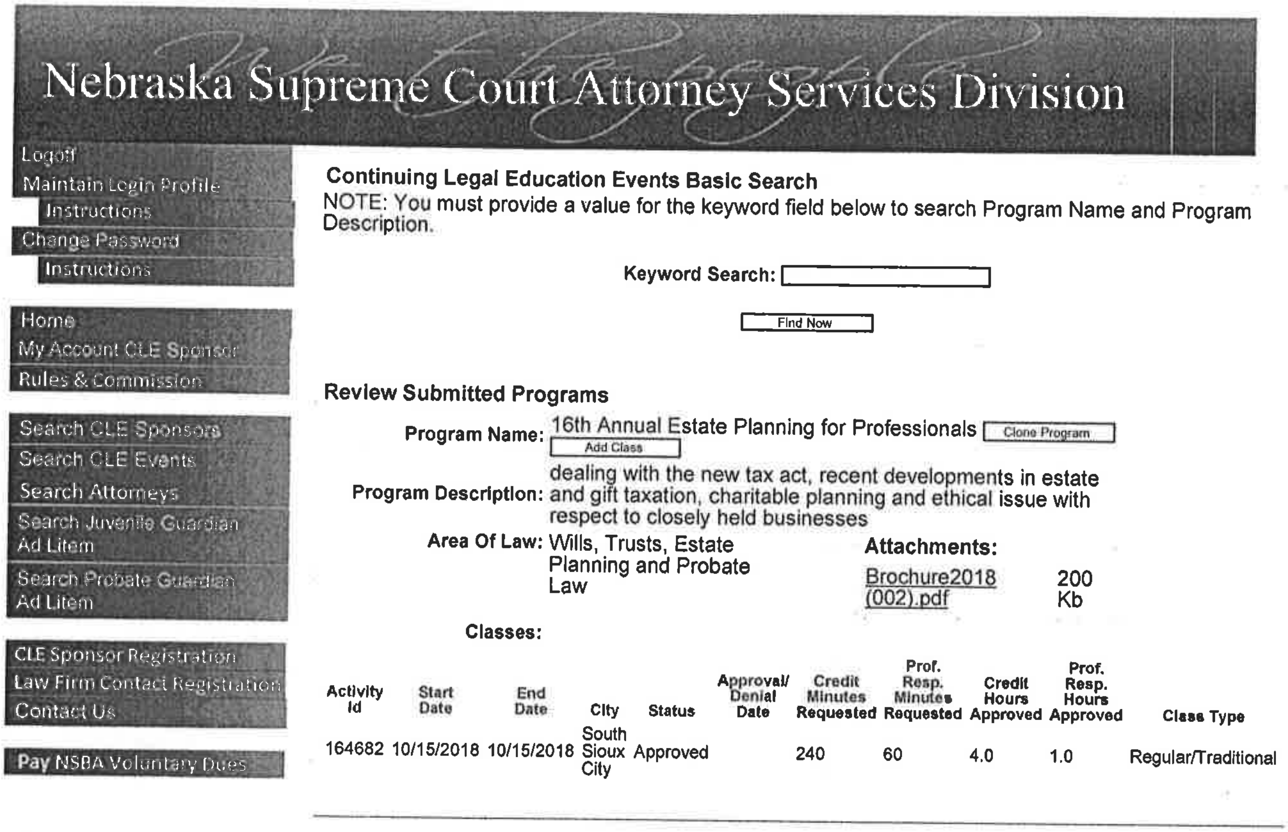

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Program Name: 16th Annual Estate Planning for Professionals

Program Description: dealing with the new tax act, recent developments in estate and gift taxation, charitable planning and ethical issue with respect to closely held businesses

Area Of Law: Wills, Trusts, Estate Planning and Probate Law

Attachments:
Brochure2018 (002).pdf 200 Kb

Classes:

Activity Id	Start Date	End Date	City	Status	Approval/ Denial Date	Credit Minutes Requested	Prof. Resp. Minutes Requested	Credit Hours Approved	Prof. Resp. Hours Approved	Class Type
164682	10/15/2018	10/15/2018	South Sioux City	Approved		240	60	4.0	1.0	Regular/Traditional

Security National Bank

Dealing with the New Tax Act and Recent Developments in Estate and Gift Taxation

Monday, October 15, 2018
8:00 a.m. – 10:10 a.m.

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The McGuireWoods Private Wealth Services Group

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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PART A – Confronting the Challenges of Tax Reform: What Happened to the Certainty of Death and Taxes?

PART B – Recent Developments

PART A

Confronting the Challenges of Tax Reform:

What Happened to the Certainty of Death and Taxes?[1]

Introduction

On December 22, 2017, President Donald Trump signed into law the tax reform bill, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (H.R. 1). The text of the Act extends nearly 500 pages. This legislation is considered the most significant overhaul of the U.S. tax code since 1986. Generally applying to taxable years beginning on and after January 1, 2018, the changes will have a profound impact on individuals, trusts, estates, and businesses in a variety of ways.

Generally, the new tax law alters individual income taxation, reduces corporate income taxes, and introduces a new form of taxing the earnings from certain pass-through entities. In addition, the law moves the United States toward a modified territorial system that alters the current tax landscape for multinational entities. And as for estate tax, gift tax, and generation-skipping transfer tax, by doubling the applicable exclusion amount to $11,180,000 indexed for inflation through 2025, Congress has reduced the number of estates to which the estate tax will apply annually to a few thousand, increased the ability of individuals to make large lifetime gifts and take advantage of the new exemption, and encouraged individuals to do more creative planning to avoid exposure to the generation-skipping transfer tax.

Summary of Provisions of Tax Act

Estate, Gift, and Generation-Skipping Transfer Taxes

Doubling of the Estate and Gift Tax Basic Exclusion Amount and GST Tax Exemption Amount. The Act temporarily doubles the basic exclusion amount for purposes of the estate and gift taxes and the exemption amount for purposes of the generation-skipping transfer ("GST") tax (the "GST exemption"). Under current law, the basic exclusion amount was scheduled to increase to $5.6 million on January 1, 2018. For decedents dying and gifts made after December 31, 2017 and before January 1, 2026 (the "Covered Years"), the basic exclusion amount now equals $10 million, adjusted for inflation annually for each taxable year after 2011. Because the GST exemption amount equals the basic exclusion amount, a corresponding increase in the GST exemption amount will also apply to generation-skipping transfers made during the Covered Years. On January 1, 2018, the basic exclusion amount and GST exemption amount will both

[1] Portions of this outline are based on materials prepared by the Tax and Employee Benefits Department of McGuireWoods LLP. Other portions of this outline were prepared by Beth Shapiro Kaufman, Miriam Wogan Henry, and Skip Fox for the ACTEC-ALI-CLE Teleconference on January 11, 2018 entitled "Confronting the Challenges of Tax Reform: What Happened to the Certainty of Death and Taxes?'

increase to approximately $11.18 million per individual (or $22.36 million for married couples).[2] These figures are approximations, subject to the IRS' official announcement of the actual figures as adjusted for inflation. As noted below, regulations are supposed to be issued to ensure that any exemption used prior to the sunsetting of the increased exemption is not clawed back if a donor who has used all of his or her exemption during life prior to the sunsetting dies after the sunsetting of the increased exemption.

* Internal Revenue Bulletin: 2018-10 (March 05, 2018).

Basic Exclusion Amount and GST Exemption Amount as Adjusted for Inflation			
2017 Amounts for Individuals		**2018 Amounts for Individuals**	
Gift & Estate Tax Basic Exclusion Amount	$5.49M	Gift & Estate Tax Basic Exclusion Amount	$11.18M*
GST Exemption Amount	$5.49M	GST Exemption Amount	$11.18M*

The temporary increase in the basic exclusion amount expires on December 31, 2025. Congress has authorized the Treasury Department to issue guidance addressing the treatment of gifts made during the Covered Years by individuals dying after 2025.

Although the increase in the basic exclusion amount and GST exemption amount will not expire until the end of 2025, individuals with significant wealth should consider making use of the increased amounts in 2018. The increased amounts provide the opportunity to leverage gifts for future generations. Estate-planning techniques that benefit most from the increases include:

- Making gifts to existing or new irrevocable trusts, including generation-skipping trusts where appropriate,
- Leveraging gifts to support the funding of life insurance or existing sales to trusts, and
- Pairing gifts with philanthropy.

The exemption will continue to be indexed for inflation, but will be indexed using the "Chained Consumer Price Index." The Chained CPI is short hand for "Chained Consumer Price Index for All Urban Consumers" and increases more slowly than the "Consumer Price Index for All Urban Consumers" or "CPI-U." Basically, the Chained CPI takes account of substitutions consumers would make in response to rising prices of certain items. For example, if the cost of a certain form of transportation went up, individuals might switch to another kind of transportation. This "substitution" is factored into the Chained CPI. Thus, inflation adjustments of the exemptions from estate, gift, and GST taxes should be smaller in the future than they would have been under prior law.

[2] Internal Revenue Bulletin: 2018-10 (March 05, 2018).

Changes to Income Taxes for Individuals, Estates, and Trusts

Tax Rates. The Act changes the federal income tax brackets and corresponding tax rates for individuals, trusts, and estates for the Covered Years. The following chart summarizes the differences between the 2018 tax rates and brackets that were scheduled to go into effect before passage of the Act, and the 2018 tax rates and brackets under the Act.

Unmarried Individuals			
Original 2018 Tax Brackets and Rates		**New 2018 Tax Brackets and Rates**	
Not over $9,525	10%	Not over $9,525	10%
Over $9,525 but not over $38,700	15%	Over $9,525 but not over $38,700	12%
Over $38,700 but not over $93,700	25%	Over $38,700 but not over $82,500	22%
Over $93,700 but not over $195,450	28%	Over $82,500 but not over $157,500	24%
Over $195,450 but not over $424,950	33%	Over $157,500 but not over $200,000	32%
Over $424,950 but not over $426,700	35%	Over $200,000 but not over $500,000	35%
Over $426,700	39.6%	Over $500,000	37%

Married Individuals Filing Joint Returns and Surviving Spouses			
Original 2018 Tax Brackets and Rates		**New 2018 Tax Brackets and Rates**	
Not over $19,050	10%	Not over $19,050	10%
Over $19,050 but not over $77,400	15%	Over $19,050 but not over $77,400	12%
Over $77,400 but not over $156,150	25%	Over $77,400 but not over $165,000	22%
Over $156,150 but not over $237,950	28%	Over $165,000 but not over $315,000	24%
Over $237,950 but not over $424,950	33%	Over $315,000 but not over $400,000	32%
Over $424,950 but not over $480,050	35%	Over $400,000 but not over $600,000	35%
Over $480,050	39.6%	Over $600,000	37%

Estates and Trusts			
Original 2018 Tax Brackets and Rates		**New 2018 Tax Brackets and Rates**	
Not over $2,600	15%	Not over $2,550	10%
Over $2,600 but not over $6,100	25%	Over $2,550 but not over $9,150	24%
Over $6,100 but not over $9,300	28%	Over $9,150 but not over $12,500	35%
Over $9,300 but not over $12,700	33%	Over $12,500	37%
Over $12,700	39.6%		

The tax brackets for individuals, estates, and trusts increase each year after 2018 based on the chained consumer price index for all urban consumers ("C-CPI-U"). As noted above, a "chained" CPI takes into account anticipated consumer shifts from products whose prices increase to products whose prices do not increase or increase at a lower rate. The result would generally be smaller inflation adjustments and higher tax levels over the long term.

The brackets and rates introduced under the Act, but not the changes to indexing, sunset on December 31, 2025, in accordance with Senate budget rules. For taxable years beginning after 2025, the brackets and rates revert to the brackets and rates in effect under current law (as adjusted for inflation). The Act does not modify the tax rates for long-term capital gains and qualified dividends. The 3.8 percent net investment income tax remains in place under the Act.

Kiddie Tax. The Kiddie Tax rules now subject the unearned income of children subject to tax at trust income tax rates:

- 10% up to $2,550
- 24% up to $9,150
- 35% up to $12,500
- 37% on excess over $12,500

Modification and Elimination of Deductions and Credits Available to Individuals, Estates, and Trusts. The Act modifies or eliminates many tax deductions and credits previously available to individuals, estates, and trusts. Here are some of the most notable changes to deductions under the Act.

- During the Covered Years, individuals may deduct state, local, and foreign taxes only when incurred in connection with a trade or business. However, an exception permits individuals to deduct up to $10,000 for the aggregate of state and local (but not foreign) property and income taxes whether or not incurred in connection with a trade or business.

- During the Covered Years, the deduction for home mortgage interest is available only for interest paid on the first $750,000 of acquisition indebtedness. However, a grandfathering provision permits taxpayers who entered into mortgages effective before December 15, 2017 to continue deducting interest paid on the first $1,000,000 of acquisition indebtedness for such existing mortgages.

- The Act suspends the deduction for interest paid on home equity indebtedness during the Covered Years (including for existing mortgages).

- During the Covered Years, the Act repeals the so-called "Pease Amendment" which imposed an overall limitation on itemized deductions of 3 percent of income over a threshold amount or 80 percent of all deductions.

- Elimination of the tax deduction for alimony for the paying ex-spouse on new divorce agreements executed after December 31, 2018 while excluding the alimony from the income of the recipient ex-spouse.

Modifications to the Alternative Minimum Tax Exemption Amount. The Act increases substantially the alternative minimum tax ("AMT") exemption amounts for individuals and repeals the corporate AMT, but does not modify generally the AMT applicable to estates and trusts.

The AMT is an alternative tax regime that applies to all taxpayers but primarily affects corporations and high-income individuals. AMT is based on the amount by which the taxpayer's alternative minimum taxable income exceeds the AMT exemption amount. The changes to the AMT exemption amounts under the Act are illustrated below:

AMT Exemption Amounts			
2017 AMT Exemption Amounts for Individuals		**New AMT Exemption Amounts for Individuals**	
Unmarried Individuals	$54,300	Unmarried Individuals	$70,300
Married Individuals Filing Joint Returns	$84,500	Married Individuals Filing Joint Returns	$109,400
Estates and Trusts	$24,100	Estates and Trusts	$24,100

The Act also increases the thresholds at which the AMT exemption begins to phase out, from $160,900 to $1,000,000 for married individuals filing joint returns and from $120,700 to $500,000 for unmarried individuals. The increase in the AMT exemption amounts and phase-out thresholds, combined with the modification to the federal income tax brackets and rates, should reduce considerably the number of individuals who are subject to the AMT.

Fiduciary Income Tax Issues. The restriction or elimination of itemized deductions will affect trusts and estates since trust taxation is based on individual income taxes. Trust expenses that are miscellaneous itemized deductions will no longer be deductible just as they will for individuals. Expenses that are deductible under Section 67(e) should continue to be deductible as costs incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in the trust or estate. Allowed deductions should include items such as trustee fees and attorney's fees. The income tax deduction under Section 691(c) for estate tax paid will remain. However, given the small number of estates owing estate tax (due to the doubling of the exemption), this deduction will provide a benefit for the estates of only the wealthiest decedents.

Permanence of Roth IRA Conversions. Individuals have had the ability to convert a traditional IRA to a Roth IRA since 1998 if they paid the income tax on the conversion. Initially, only individuals with adjusted gross income under $100,000 could do a conversion from a traditional IRA to a Roth IRA. This cap was removed for 2010 and later. Individuals doing a conversion could reverse the conversion until the extended due date of the individuals' tax returns for the conversion year. The Tax Act eliminates the ability to reverse course and undo a conversion starting in 2018.

Impact of Tax Act on Businesses and Their Owners

Taxation on U.S. Businesses.

Corporate Income Tax and Corporate AMT. The Act provides for a permanent 21 percent flat corporate income tax rate and a repeal of the corporate AMT for taxable years beginning after December 31, 2017. The Act also reduces the 80 percent dividends-received deduction to 65 percent, and reduces the 70 percent dividends-received deduction to 50 percent. The new lower corporate income tax rate may cause more businesses to utilize the corporate structure, especially in scenarios where there will be limited distributions to shareholders and earnings will be used to pay down debt or finance acquisitions or growth.

Corporate Net Operating Losses. The new tax law limits the deduction for net operating loss carryovers to 80 percent of taxable income, eliminates the carryback of such losses for most companies, and provides for an indefinite carryforward. This provision is generally effective for losses arising in tax years beginning after 2017.

Deduction for Qualified Business Income of Pass-Through Entities. A new deduction will be available to individuals, trusts and estates for qualified business income from pass-through and disregarded entities. Importantly, the deduction against qualifying income would expire for tax years beginning after December 31, 2025.

During the Covered Years, individuals, estates, and trusts may deduct from their taxable income 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, including a disregarded entity treated as a sole proprietorship, subject to certain limitations.

Generally, a taxpayer’s qualified business income is derived from an active trade or business. It excludes any amounts paid by an S corporation treated as reasonable compensation, guaranteed payments to a partner in a partnership, and amounts paid to a partner acting in a capacity other than as a partner. The Act excludes income generated from certain specified service businesses (such as law, health, accounting, and financial services) from qualified business income status if the taxpayer’s taxable income exceeds certain thresholds. Interestingly, engineering and architectural firms are not listed as per se service businesses.

The pass-through deduction is limited to the lesser of: (i) 50 percent of the W-2 wages paid by the qualified business, and (ii) 25 percent of the W-2 wages plus 2.5 percent of the depreciable property in service in the qualified business.

Private equity funds and real estate companies whose employees are “housed” in separate related party entities may be limited in taking advantage of this deduction due to the wage limitation. However, this new deduction could mean significant income tax savings for many business owners.

Carried Interest. The Act institutes a three-year holding requirement for carried interests (defined as “applicable partnership interests”) to be eligible for long-term capital gain treatment. If such holding requirement is not satisfied, any capital gain recognized by the holder of “applicable partnership interests” will receive short-term capital gain treatment. An “applicable partnership interest” is a partnership interest transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer or certain related persons in an “applicable trade or business.” Covered trades or business are activities that are conducted on a regular, continuous, and substantial basis and that consist, in whole or in part, of:

(1) raising or returning capital; and

(2) either developing, or investing in or disposing of (or identifying for investing or disposition) “specified assets,” such as securities, commodities, real estate held for rental or investment, or cash or cash equivalent.

There are two notable carve-outs from the definition of applicable partnership interests. First, a partnership interest held by a corporation is excluded. Second, applicable partnership interests do not include capital partnership interests that provide the partner with the right to share in partnership capital commensurate with the amount of capital contributed or the value of such interest included in income under Section 83 of the Internal Revenue Code upon the receipt or vesting of the interest.

The new provision applies notwithstanding the application of Section 83 to the interest or whether the holder made a Section 83(b) election with respect to the interest. Interestingly, the Act does not include rules “grandfathering” applicable partnership interests held as of the effective date of the Act.

There will likely be future guidance in this area as the new tax law authorizes the U.S. Department of the Treasury to promulgate regulations necessary to carry out the purposes of the provision. Also, portions of the technical language of the provision are ambiguous, so clarifying authority will be necessary.

Business Interest Expenses. Business interest expenses once deductible under Section 163 of the Internal Revenue Code now may be limited to 30 percent of the taxpayer’s earnings before interest, tax, depreciation and amortization (“EBITDA”) for taxable years beginning after 2017 and before 2022, and limited to 30 percent of a taxpayer’s earnings before interest and tax (“EBIT”) for taxable years beginning after 2021. At the taxpayer’s election, the limitation does not apply to interest incurred by the taxpayer in any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. It also does not apply to regulated public utilities, certain electric cooperatives and taxpayers with average annual gross receipts for the current and prior two taxable years that do not exceed $25 million.

Disallowed interest expenses can be carried forward indefinitely. Also, the business expense limitation is applied at the partnership level for businesses operated in a partnership. Any interest that cannot be deducted by the partnership because of the limit would be allocated to the partners in the same ratio as net income and loss, and could be used in future years to offset any excess income allocations. The exclusion of interest deductions will impact businesses with business interest expenses, particularly taxpayers with large annual revenues beginning in 2021 when the 30 percent limit is applied to a much smaller earnings base.

Bonus Depreciation. The Act modifies bonus depreciation under Section 168(k) of the Internal Revenue Code to allow 100 percent expensing for property placed in service after Sept. 27, 2017, and before January 1, 2023, and then phases out bonus depreciation with 20 percent reductions each year. Property "acquired" before September 28, 2017, including under a binding written contract, will be subject to the old bonus depreciation rules, which is 50 percent through 2017, 40 percent in 2018, and 30 percent in 2019 with no bonus depreciation thereafter. The Act removed the "original use" requirement for bonus depreciation. This means property previously placed in service will qualify for 100 percent bonus depreciation when acquired by another party before January 1, 2023.

Like-Kind Exchanges of Real Property. The Act limits the like-kind exchange rules to exchanges of real property that is not held primarily for sale. Thus, personal property (tangible or intangible) is no longer eligible for like-kind exchange treatment. This new provision applies to exchanges completed after December 31, 2017.

Partnership Technical Terminations. The new tax law eliminates the current rules regarding partnership technical terminations under Section 708(b)(1)(B). Technical terminations occur when 50 percent or more of interests in both profits and capital are transferred in any rolling 12-month period. This results in the technical termination of the current partnership and the formation of a new partnership for federal tax purposes, with depreciation schedules restarted in the new partnership. Many partnership agreements have prohibitions on transfers that could result in a technical termination, including upstream transfers. The removal of the partnership technical termination rules will allow partners to more easily make transfers of their partnership interests, and even avoid indemnification if the partnership documents required indemnification by the transferring partner for technical terminations.

Section 199 Deductions. The Act eliminates the deduction for income attributable to domestic production. Section 199 of the Internal Revenue Code allowed for a 9 percent deduction from income for qualifying production activities income, including the domestic manufacture of tangible personal property or computer software and energy generation from renewable energy projects. The elimination of this deduction will impact owners of qualifying production property since the deduction is no longer available.

International Tax.

New Participation Tax Exemption. The Act adopts a "territorial" tax regime and exempts from U.S. tax the foreign-source portion of dividends received from certain foreign corporations. In concept, the exemption is similar to the "participation exemption" available under the laws of many foreign countries and used by foreign corporations resident in that country to avoid tax on dividends received from foreign subsidiaries. Newly enacted Section 245A of the U.S. Internal Revenue Code provides a 100 percent dividends-received deduction for certain eligible U.S. shareholders. To be eligible, the recipient must be a U.S. C corporation that owns at least 10 percent of the stock of the paying foreign corporation—and has retained that stock ownership for a specified period of time. The exemption is not available to S corporations or individuals.

Tax on Deemed Repatriation of Accumulated Foreign Earnings. To prevent U.S. corporations from using the new U.S. tax exemption to repatriate, on a tax-free basis, cash accumulated by foreign subsidiaries in prior years, the Act requires certain U.S. taxpayers to include in taxable income the taxpayer's allocable share of a foreign corporation's pre-2018 accumulated foreign earnings, as adjusted for foreign deficits and other items. These earnings will be subject to U.S. tax at an effective tax rate of 15.5 percent, to the extent attributable to cash or certain other liquid assets, or an effective tax rate of 8 percent if the earnings have been reinvested by the foreign corporation in illiquid assets. These effective rates are derived via a new deduction that has the effect of reducing the U.S. taxpayer's higher statutory tax rate to the reduced 15.5 percent or 8 percent effective rate.

Notably, shareholders in certain S corporations will be required to include in taxable income their allocable shares of the foreign corporation's unremitted earnings. To minimize the tax impact to S corporation shareholders, however, the Act defers or postpones the time at which this additional U.S. tax must be paid. More specifically, a U.S. C corporation must pay U.S. tax on its allocable share of unremitted foreign earnings over an eight-year period (with an acceleration in the event of certain triggering events). Shareholders of an S corporation, however, may elect to defer payment of this U.S. tax until there is a triggering event. Notably, the definition of a "triggering event" includes the termination of S corporation status and the sale of S corporation stock. Further, the S corporation is liable in the event the shareholder fails to pay such tax. Thus, shareholders of an S corporation that are subject to this new U.S. tax on unrepatriated foreign earnings must carefully consider any actions that would accelerate the payment of this tax.

Rules to Minimize Base Erosion: The Act creates a new base erosion and anti-abuse tax (the "BEAT"). The BEAT is intended to apply to companies that significantly reduce their U.S. tax liability by making cross-border payments to affiliates. The BEAT applies if 10 percent of the cross-border payment amounts exceed the company's regular U.S. tax liability.

The Act adopts a number of base erosion provisions, including the following:

- Denial of new participation tax exemption (discussed above) for passive foreign investment company (PFIC) dividends and purging distributions.

- Recapture of accumulated losses upon incorporation of a foreign branch.

- Repeal of Section 367(a)(3), which currently permits U.S. taxpayers to transfer active trade or business assets to a foreign corporation on a tax-deferred basis.

- Expansion of the pool of items of intangible property (including goodwill) that, if transferred by a U.S. taxpayer to a foreign corporation, would be subject to tax.

- New Code Section 951A, by which some U.S. taxpayers will pay tax on certain income earned by controlled foreign corporations in excess of a specified return on tangible business assets.

- New Section 250, by which U.S. corporations that derive certain income from unrelated foreign persons will benefit from a new tax deduction.

- Adoption of an anti-inversion rule that denies the participation exemption and imposes a 35 percent tax rate (and applies certain other rules) in respect of "expatriated entities" during the 10-year period following enactment of the Act

Other Tax Rules. The Act also amends, repeals, or enacts a number of other U.S. tax rules. For example, among other changes, the Act expands the definition of "U.S. shareholder" for purposes of the Subpart F rules, repeals the foreign tax credit available under Section 902 in respect of future foreign dividends and creates a new foreign tax credit limitation, and revises source rules for sales of inventory and certain partnership interests.

The tax law's changes to domestic, international and cross-border transactions will have a significant impact on the structure and operation of transactions. In addition to creating additional complexity, these changes raise new issues for U.S. taxpayers that own, acquire or sell U.S. or foreign business ventures. Businesses and business owners need to carefully re-evaluate their transaction and operational structures in light of the Act.

Charitable Issues

Charitable Contribution Deduction. For the Covered Years, the annual limit on aggregate deductions for gifts to public charities and certain other organizations will increase from 50 percent to 60 percent of adjusted gross income. At the same time, the standard deduction will almost double—from $6,350 to $12,000 for single individuals and from $12,700 to $24,000 for married couples—and will be indexed for inflation, and deductions for state and local taxes, mortgage interest, uncompensated employee expenses, casualty losses, home equity loans, gambling losses, and miscellaneous itemized deductions will be substantially curtailed.

These changes, coupled with the increased transfer tax exemptions described below, seem likely to cause a dramatic reduction in the number of donors who can derive any tax benefit from their charitable gifts.

The Act prohibits donors from deducting amounts paid for the right to purchase tickets to college athletic events. Current law allows a charitable deduction for 80 percent of such payments.

The Act also allows an electing small business trust (which is a type of trust eligible to own stock in an S corporation) to follow the charitable contribution deduction rules for individuals, including applicable percentage limitations and carryforward provisions.

Additionally, the Act eliminates the statutory provision that excuses a donor from obtaining a contemporaneous written acknowledgement of a charitable gift if the donee organization files a return with the required information.

Unrelated Business Income Tax (UBIT). The Act requires tax-exempt organizations to calculate income from each unrelated trade or business separately and prohibits them from offsetting taxable income from one such activity with losses from another.

Colleges and Universities. The Act imposes a 1.4 percent excise tax on private college and university endowments that have at least 500 students (more than 50 percent within the United States) and have investment assets valued at $500,000 or more per full-time student. Investments of any organization related to the college or university, including supporting organizations, would count toward the asset threshold. Below are a few additional notes regarding the applicability of these provisions:

- The Act counts all students, not just “tuition-paying” students, in determining whether the tax applies to a particular institution.

- Investments of any organization related to the college or university, including supporting organizations, would count toward the asset threshold.

- The tax would not apply to endowments of public colleges and universities.

Approximately 27 universities and colleges will be affected by this tax.

Exempt Organizations as Employers. A tax-exempt employer would pay excise tax at the corporate rate (21 percent under the Act) on compensation of more than $1 million paid to any of its five highest-paid employees. The tax also would apply to a parachute payment that exceeds three times the base salary of a “highly compensated employee” (under current Section 414(q)). Compensation would be treated as being paid when rights to it are not subject to a substantial risk of forfeiture. A special exclusion applies to payments to a licensed medical professional for medical or veterinary services.

Tax-exempt employers also would pay unrelated business income tax on the value of transportation fringe benefits and on-premises gyms and other athletic facilities that employees can exclude from their taxable income.

Financing for Exempt Organizations. The Act would impose income tax on interest from advance refunding bonds and prohibit issuance of tax credit bonds after 2017.

Broadening Recipients for 529 Accounts. The Act would allow payments of up to $10,000 per student for each taxable year from 529 college savings plans to elementary and secondary schools, including public, private, or religious schools. Qualified expenses would include tuition, fees, books, and other related costs. A provision to include the costs of home schooling was removed. The Act also permits transfers to an ABLE Account (which were created by the Achieve a Better Life Experience Act of 2014) for individuals with disabilities that will not affect their qualification for SSI, Medicaid, and other public benefits.

Provisions Not Included in Act. The final Act did not include several provisions that were in earlier versions of the House and/or Senate bills. Thus, the Act does not:

- repeal deduction for student loan interest;

- repeal deduction for qualified tuition and related expenses;

- repeal exclusion for qualified tuition reductions;

- repeal exclusion for interest on U.S. savings bonds used for higher education expenses;

- repeal exclusion for education assistance programs;

- allow 529 plan accounts to be opened for an *in utero* beneficiary;

- increase 14 cents-per-mile statutory cap on deductions for charitable use of a personal vehicle;

- repeal estate tax or generation-skipping transfer tax;

- impose UBIT on all Internal Revenue Code Section 501(a) organizations;

- impose UBIT on income from research if results are not publicly available;

- impose UBIT on income from sale or licensing of a tax-exempt organization's name or logo;

- modify exclusion for housing provided for the employer's convenience;

- permit private foundations to own an independent for-profit business without violating the excess business holdings rules;

- impose uniform 1.4 percent excise tax on private foundation investment income;

- require private foundation art museums to be open to the public;

- modify intermediate sanctions rules for private foundations;

- repeal new market tax credits;

- repeal private activity bonds;

- impose new disclosure requirements for donor-advised funds;

- prohibit tax-exempt bond financing for pro sports stadiums; and

- modify political campaigning prohibition for Section 501(c)(3) organizations (the so-called "Johnson Amendment").

Planning for Clients after the Tax Act

I. Estate Planning after the 2017 Tax Act

A. While the doubling of the estate tax exemption to $10 million (indexed for inflation) will allow most individuals to escape federal estate taxes, estate planning will still be necessary to permit an individual to pass assets to his or her beneficiaries in the form that he or she would like. This could include outright gifts or gifts in trust. One has only to look at the contest over the estate of Prince, who died in 2016 with no will, to see the value of estate planning. Prince's heirs came out of the woodwork to fight over his estate.

B. The Internal Revenue Service provides the following information on the number of estate tax returns filed in 2016, the latest year for which information is available.

1. Of all 12,411 estate tax returns filed in 2016, 8,270 (2/3 of all returns filed) reported a gross estate LESS THAN $10 million. 4,142 returns were filed with a gross estate MORE THAN $10 million. Under the 2017 Tax Act, only about 1 out of every 3 returns filed last year would be required to file in coming years. 12% of all returns were for estates over $20 million. The table looks like this:

All Returns Reporting < $10 million	8,270
% of All Returns Filed	67%
All Returns Reporting Gross Estate > $10 million	4,142
% of All Returns Filed	33%
All Returns Reporting Gross Estate > $20 million	1,507
% of All Returns Filed	12%

2. One interesting note: The IRS tracks attorneys' fees as a deductible expense in a separate column. The total attorneys' fees claimed on all returns filed in 2016 with gross estates LESS THAN $10 million was approximately $213 million dollars ($25 million for estates less than $5 million; $188 million for estates between $5 to $10 million). No doubt some percentage of attorneys' fees will still be required for administration, but this could be a significant impact on the estate tax return preparation industry.

3. One relevant consideration regarding returns reporting assets of $20 million or more is whether the return is subject to tax. If one assumes that a married couple could take advantage of the basic exclusion amount up to $22 million, one might assume that some significant percentage of the taxable returns filed in 2016 reporting gross estates more than $20 million dollars reflects the number of taxpayers, going forward, that will PAY estate tax annually. This does not account for a married couple that makes significant lifetime gifts and it does not account for the number of taxpayers that use the charitable deduction, or for another reason, do not end up paying tax at the death of the survivor. But the number of returns that reported paying tax in 2016 with a gross estate of more than $20 million is 911, or 7% of all returns filed.

C. The estate plans of all clients should be reviewed to determine the possible impact of the changes in the estate, gift, and generation-skipping taxes on them.

D. Summary of Possible Strategies:

1. Updating of estate plans to match intent of clients with exemption.

2. Broad line division between estates under $20 million and equal to or above $20 million.

3. Examine strategies to protect against future drop in exemption (such as expiration of current exemption in 2026 or earlier or later action by a new administration and Congress.

4. Continued role of techniques such as gifts, long-term trusts, GRATs, SLATs, and sales to defective grantor trusts

5. Late allocation of additional GST exemption to existing trusts to improve efficiency.

6. Modification of QTIP Trusts and GST Trusts to pick up basis step-up.

7. Structure of businesses.

8. Is there a conflict between the basis adjustment and discounts in planning?

E. Planning for Individuals Not Subject to Estate Tax and for Whom Planning is Unnecessary to Avoid Estate Tax

1. Primary Objectives

a. An estate plan is a plan for transporting one's wealth. Like any transportation plan, it designates a destination—the persons who will receive the property. It also can provide instructions on how the property may be used. In transportation, minimizing breakage is a goal. Likewise, in an estate plan, minimizing loss of property, to taxes or to waste, is an important goal in establishing a plan to pass property as the client wishes.

b. In order to accomplish these goals, an individual will need to formulate his or her specific objectives and desires about the disposition of his or her property, the use of trusts, and the appointment of fiduciaries. The estate planning professional must assist the individual in this process by explaining the available alternatives, and the impact of tax planning and creditor protection considerations.

c. Wills, revocable trusts, powers of attorney, and medical directives will still be needed for individuals not subject to estate tax.

F. Benefits of Placing Property in Trust

1. Individuals often believe that they need nothing more than a simple will if their estates are below the applicable exclusion amount and they do not anticipate that federal estate tax will be due at either their death or the death of their spouse. A will that leaves all the assets to the spouse and, upon the spouse's death, divides the assets equally among the children is considered sufficient to protect the family adequately. A closer look points out the risks inherent in such a plan.

2. If an individual leaves even modest amounts of money to a spouse who has never had any experience with financial management and investment

decisions, he or she may be placing an unfair burden upon the spouse. This type of burden translates into anxiety instead of security.

a. The surviving spouse may remarry, and all or a portion of the assets originally intended to go to children may end up in the hands of the new spouse, or children of the second marriage.

b. Even if the surviving spouse does not remarry, he or she may be put in the position of saying "no" to a child who wishes to use the inherited wealth for a risky new business venture or some speculative investment. Depending upon the relative strengths of the child and surviving spouse, imprudent decisions may be made which could rapidly dissipate the property left for the family.

c. A surviving spouse who has been insulated from financial matters may, upon receiving an inheritance, may fall prey to unscrupulous people who do not act in the spouse's best interests. Alternatively, the surviving spouse could become overwhelmed by the immediate feeling of wealth and independence and live in a manner that could quickly exhaust the remaining estate.

3. By using trusts to transfer property, either during life or at death, the donor is able to maintain an element of control over the property. The donor can designate under what circumstances and for what purposes a beneficiary will receive that property or its income. Trusts also permit the donor to determine who will manage the property as trustee. Other advantages of trusts include the following:

a. Retention of property in trust preserves the benefits of the investment and management skills of the trustee.

b. A trust can protect assets from the claims of third-party creditors of the beneficiary, such as the plaintiff in a lawsuit or a spouse in a failed marriage. Generally, a creditor or litigant cannot gain access to assets set aside in a properly drafted trust by someone other than the beneficiary. The same is generally true with respect to a divorcing spouse, although state law varies on the degree to which courts can consider the existence of trust assets in determining the division of assets upon divorce.

c. Children who have not fully matured may rapidly dissipate an outright inheritance, whereas a trust can provide for incremental distribution of inheritances.

d. Large outright distributions may spoil children and destroy their incentive to provide for self-support.

4. On the other hand, an overly restrictive trust may prevent an entrepreneurial child from reaching the property and exploiting a business opportunity. A well-drafted trust can be flexible enough to allow a capable beneficiary to take advantage of such opportunities.

5. Placing property in trust may grandfather trust assets from future estate tax changes such as a return to the pre-2018 rules in 2026 as provided in the Act.

G. Advising on Creditor Protection

1. Basic Creditor Protection

a. Outright Gifts of Property. Outright gifts are a simple way for a client to protect his or her assets from the claims of future creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, there may be consequences under the Fraudulent Conveyance statutes.

b. Trusts. Trusts may be the most important regularly used and accepted asset protection tool available. For transfer of property by gift, a trust can be used to alleviate the client's concerns about the beneficiary's imprudent use of the property.

c. Co-Ownership. Different forms of co-ownership, such as tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

d. Trusts for Disabled Beneficiaries. The most likely potential creditor of a disabled beneficiary is the federal, state, or local agency that provides public assistance to that beneficiary. Over the past 10 to 15 years, public agencies have become more aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit agencies to seek reimbursement and that define the assets which are available to the government agency. These statutes must be considered carefully when drafting a trust that is designed to provide supplemental benefits to a disabled person in order to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

(1) State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be treated as an asset of the beneficiary for the purpose of determining eligibility for

public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources). Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

e. Exempt Assets. Separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations.

(1) Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality.

(2) Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre.

f. Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

g. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, like Texas. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans.

2. Premarital Agreements

   a. Work will be needed to provide for the distribution and ownership of assets for couples about to marry.

   b. Premarital agreements will continue to be an important component of this advice and planning.

3. Limited Partnerships

   a. The family-owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including investment efficiencies, valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

   b. With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership is generally limited to his investment in the partnership. This prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

   c. A limited partnership also can provide a modest level of creditor protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect a limited partnership interest from the claims of creditors of the partner by mandating an unattractive remedy for a creditor seeking that partner's interest.

   d. Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that a court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

4. Limited Liability Companies

a. The limited liability company ("LLC") is a viable alternative to the use of a limited partnership. The LLC first became available in Wyoming in 1977 and is now available in almost every state. The LLC has the limited liability of a corporation, but preserves the flow-through treatment of taxable income (or loss) of a partnership. The LLC can provide an attractive alternative to the use of a general or limited partnership, especially where there is a desire to limit the personal liability of the family members in relation to the activities of the entity.

b. With respect to asset protection issues, many state LLC statutes contain charging order Sections similar to that found in the RULPA. Also, LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

(1) A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

(2) An assignee will not become a member of the LLC without the unanimous consent of the other members; and

(3) An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

5. Domestic Asset Protection Trusts

a. Certain states permit the settlor of an irrevocable trust to obtain spendthrift protection from an irrevocable trust if certain require are met.

b. While Missouri was the first state to enact Domestic Asset Protection Trust legislation in 1986, few attorneys outside of Missouri paid attention to it or were even aware of it. However Domestic Protection Trusts gained public awareness when, in 1997, both Alaska and Delaware enacted legislation permitting Domestic Protection Trusts.

c. As of January 1, 2018, the following 18 states allow such self-settled asset protection trusts: Alaska, Colorado, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

d. The requirements of such a trust vary by state, but basic requirements in each of these Domestic Asset Protection States are the following:

(1) There must be a resident trustee in the state.

(2) Some of the assets of the trust must be held in the state.

(3) Some of the administration of the trust must take place in the state.

(4) The transfer of assets to the domestic asset protection trust cannot be a transfer in fraud of creditors.

(5) The trust must be irrevocable.

(6) The settlor is a discretionary beneficiary of the income and principal of the trust.

6. Offshore Protection Trusts

a. Offshore Protection Trusts have become one of the most talked about estate planning techniques for many years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions, usually former British colonies or current British dependencies permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

b. Creditor Protection Benefits

(1) An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets.

(2) The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding.

(3) Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments. Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction.

(4) As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions which protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

7. Individuals may still want to establish long-term trusts that could last several generations to protect assets from creditors, to provide centralized management of assets, and also to protect the assets in the trust from the imposition of a future estate, gift, or generation-skipping transfer tax.

a. The ability to established long-term irrevocable trusts for several generations has been greatly aided by the enactments of laws in many states that have either eliminated or greatly extended the common law rule against perpetuities. In fact, without a gift tax, unlimited amounts could be placed in such a trust.

b. The common law Rule Against Perpetuities (the "Rule") provides that no interest is valid unless it vests or fails within a life in being plus twenty-one years. Currently, twenty states effectively have abolished the Rule. Nine states have repealed the Rule outright. A tenth (Delaware) has repealed the Rule with respect to interests in personal property. An additional nine states and the District of Columbia have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In 2000 Florida extended the perpetuities period to 360 years, and in 2001 Washington extended it to 150 years. In 2003, Utah extended its perpetuities period to 1,000 years. Also, in 2003, Wyoming adopted an opt-out provision for personal property and extended the perpetuities period to 1,000 years. In 2005, Nevada extended the perpetuities period to 365 years. In 2006, Colorado extended the perpetuities period to 1,000 years. In 2007, Tennessee extended the perpetuities period to 360 years.

c. Repeal Legislation. Statutory provisions in Alaska, Idaho, Kentucky, New Jersey, Rhode Island, South Dakota, and Wisconsin each provide that the Rule is not in force in the respective states, while Pennsylvania provides for this for interests created after December 31, 2006. Statutes in effect in Idaho, South Dakota, and Wisconsin provide that the repeal of the Rule applies retroactively. By contrast, New Jersey's statute provides that it shall not be applied retroactively. It is unclear whether the repeal of the Rule in Alaska or Rhode Island applies retroactively. North Carolina repealed the Rule effective August 9, 2007. A state constitutional problem arose because of the provision of Section 34 of Article I of the North Carolina Constitution that provides "Perpetuities and monopolies are against the genius of a free state and shall not be allowed." On February 2, 2010, the North Carolina Appellate Court upheld the constitutionality of the North Carolina repeal. Hawaii repealed the Rule with respect to its form of domestic asset protection trust that became effective July 1, 2010.

d. Delaware and Michigan Partial Repeal Legislation. Delaware has repealed the Rule only with respect to interests in personal property, but replaced the common law Rule with a perpetuities period of 110 years for real property held in trust. It is unclear whether either of these provisions apply retroactively to existing trusts. Michigan has repealed the Rule with respect to personal property effective May 28, 2008.

e. Opt-Out Legislation. The remaining twelve states (plus the District of Columbia) that have effectively abolished the Rule have done so by providing settlors with the power to opt out of the Rule's application to their trusts. These states include Illinois, Maine, Maryland, Ohio, Arizona, Colorado, Missouri, New Hampshire, Virginia, and Wyoming.

8. Irrevocable Life Insurance Trusts

a. Clients may still create irrevocable life insurance trusts as a way to transfer the death benefits of life insurance policies to family members without adverse gift tax consequences even if there are no estate tax consequences. They may do so to provide creditor protection to the beneficiaries. This will require planning in many instances to qualify transfers to the trusts for the gift tax annual exclusion through the use of Crummey powers and to minimize the exposure of the holders of the Crummey powers to potential gift tax exposure through the use of vested interests or hanging powers of withdrawal for example.

H. Income Tax Planning

1. Clients will still need advice on both federal and state income taxes.

2. Federal Fiduciary Income Tax

a. The fiduciary income tax found in Subchapter J of the Internal Revenue Code is one of the more complex and confusing tax provisions.

b. Among the complex areas of Subchapter J are:

(1) What makes a trust a grantor trust for income tax purposes?

(2) Distributable Net Income ("DNI") and what it really means.

(3) The lack of simplicity of simple trusts, and the complexity of complex trusts.

(4) The limitations on deductibility of trust expenses.

(5) Timing distributions to the advantage of beneficiaries.

(6) Making the Section 645 election work for clients.

(7) The ins and outs of equitable adjustments and private unitrusts.

3. Changes brought about by the 2017 Tax Act

a. The 2017 Tax Act continued the compression of the income tax rates for irrevocable non-grantor trusts and estates with the top 37 percent rate applying to income greater than $12,500 compared with the top 37 percent rate for unmarried individuals applying to income over $500,000.

b. The 2017 Tax Act added a new Section 67(g) which provides that no miscellaneous itemized deductions (which previously could be taken to the extent that they exceeded two percent of adjusted gross income) will be allowed for the tax years 2018 through 2025. Most commentators believe that the Section 67(g) prohibition on taking deductions does not apply to the expenses covered by Section 67(e), which permits a full deduction for expenses which would not have been incurred if the property were not held in an irrevocable non-grantor trust or estate.

c. The following items should continue to be deductible for irrevocable non-grantor trusts and estates:

(1) State and local income and property taxes on assets held in a trust or estate up to the $10,000 cap.

(2) State personal and real estate taxes on a trade or business owned by a trust or estate.

(3) Interest (subject to the same rules and limits as before 2018)

(4) Charitable distributions for amounts specifically allocable or payable to charity by the governing will or trust instrument pursuant to Section 642(c).

(5) Amortized bond premiums and original issue discount.

(6) Depreciation and depletion expenses.

(7) Costs of preparing estate tax returns and fiduciary income tax returns.

(8) Legal fees related to the administration of a trust or estate.

(9) Administrative fees for items such as appraisals and accountings.

4. State Income Taxation of Irrevocable Non-grantor Trusts

a. Currently seven states—Alaska, Delaware, Florida, Nevada, South Dakota, Texas, Washington and Wyoming—do not tax the income of trusts. The other states and the District of Columbia do tax the income of trusts to a greater or lesser extent.

b. If a trust is treated as a grantor trust for federal income tax purposes, all income (ordinary and capital gains) will be taxed to the grantor of the trust. Most states follow the substance of the federal grantor trust rules. If a trust is a grantor trust for federal income tax purposes, the trust will be treated as a grantor trust for state income tax purposes. Pennsylvania and Tennessee do not follow the federal grantor trust rules for irrevocable trusts.

c. Every state follows the rule that to the extent that income is distributed from an irrevocable non-grantor trust to a beneficiary, the beneficiary pays the tax and not the trust. Consequently, in examining the income taxation of a trust or estate from a state law perspective, one is primarily looking at the taxation of income accumulated in a trust as well as capital gains.

d. In the remainder of this Section, the focus will be on the state income taxation of irrevocable non-grantor trusts. Non-grantor irrevocable trusts are generally taxed for state income tax purposes on one or more of the following bases:

(1) The trust was created pursuant to the will of a testator who lived in the state at the time of his or her death.

(2) The creator of an inter vivos trust lived in the state at the time the trust became irrevocable.

(3) The trust is administered in the state.

(4) One or more trustees live or do business in the state.

(5) One or more beneficiaries live in the state.

e. The trust that meets one or more of the bases for taxation in a state is generally referred to as a "Resident Trust."

f. The bases for the state income taxation of non-grantor trusts vary from state to state:

(1) Trust created by will of resident. Connecticut, District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax a trust that is created by the will of a decedent who was a resident of the state at the time of his or her death. Other states, such as New Jersey and New York, require that such a trust have Resident Trustees, assets, source income, or a resident beneficiary before they will tax such a trust.

(2) Inter vivos trust created by resident. The District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax an inter vivos trust if it becomes irrevocable when the creator lived in the state.

(3) Trust administered in the state. Colorado, Georgia, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin tax the trust if a trust is administered in that state. Idaho and Iowa tax a trust if it is administered in the state if this basis is combined with other factors. Hawaii requires that a trust administered in Hawaii have at least one resident beneficiary for the trust to be taxed in Hawaii. Utah, since 2003, has permitted a Utah corporate trustee to deduct all nonsource income of a trust administered in Utah.

(4) Resident Trustee. Arizona, California, Georgia, Kentucky, Montana, New Mexico, North Dakota, Oregon and Virginia tax an irrevocable trust if one or more trustees reside in the state.

(5) Resident beneficiary. California, Georgia, North Carolina, North Dakota and Tennessee tax a trust if it has one or more resident beneficiaries.

g. State laws vary considerably on the rules on which state income tax is based. One must look at the law of each state in determining whether that state's income tax will apply to a particular trust.

h. As can be seen above, some states apply more than one basis in determining whether a trust is subject to income taxation of that trust. For example, Virginia taxes the income of a non-grantor trust if (i) the trust was created by the will of a Virginia decedent; (ii) the trust was created by a Virginia resident; (iii) the trust is administered in Virginia, such as, for example, its assets are located in Virginia or its fiduciary is a resident of Virginia.

i. Examples of different states:

(1) The opportunity for reducing taxes can be important. State fiduciary income tax rates range from 3.07% in Pennsylvania to as high as 12.846% in New York City.

(2) New York. New York defines a Resident Trust as a trust created by a New York resident or grantor. New York does not tax a trust if a trust has no New York trustees, assets, or source income.

(3) Connecticut. Connecticut basically taxes irrevocable trusts that are created by a Connecticut testator or a person who is a resident of Connecticut at the time the trust became irrevocable.

(4) Delaware. Delaware generally does not impose any income tax upon Resident Trusts except in cases where one or more trust beneficiaries live in Delaware and then only upon the portion of the trust income attributable to the beneficiaries who reside in Delaware.

(5) Maryland. Maryland taxes an irrevocable trust created by a Maryland testator or grantor if the trust was created under the will of a decedent domiciled in Maryland on the date of decedent's death, the creator or grantor of the trust is a current resident of Maryland, or the trust is principally administered in Maryland.

(6) Virginia.

(a) Virginia, as noted above, has a broad definition of a Resident Trust subject to Virginia taxation. The definition is:

> A trust created by the will of a decedent who at his death was domiciled in the Commonwealth; a trust created by or consisting of property of a person domiciled in the Commonwealth; or a trust which is being administered in the Commonwealth.

(b) The Virginia Administrative Code expands on this definition by adding that a trust is considered to be administered in Virginia if "its assets are located in Virginia, its fiduciary is a resident of Virginia or it is under the supervision of a Virginia court."

(7) Missouri. A trust will be subject to Missouri income tax if it was created by the will of a Missouri decedent or it is an inter vivos trust created by a Missouri resident. In addition, the trust must have a resident income beneficiary on the last day of the taxable year if the trust is to be subject to tax in Missouri.

(8) California. A trust is a California resident for income tax purposes if a trustee or non-contingent beneficiary is a resident of California, regardless of the residence of the settlor. With respect to corporate fiduciaries, the residence of the corporate fiduciary is the place in which the corporation conducts the major portion of the administration of the trust.

j. Given the complexity of and the differences between the rules governing the income taxation of trusts and estates by different states, an irrevocable non-grantor trust may be subject to income taxation in more than one state.

k. Responses to DING trusts, NING trusts, and Attempts to Minimize State Income Tax

(1) A "DING" trust, or "Delaware Incomplete Non Grantor" Trust, is an irrevocable trust established under the laws of Delaware. When established in Nevada, such a trust is referred to as a "NING" trust.

(2) Such a trust has the following features:

(a) The trust is irrevocably established in a jurisdiction without state income tax on trusts (in the case of a DING, Delaware; and in the case of a NING, Nevada) by a settlor from another jurisdiction;

(b) The settlor retains sufficient control such that the trust is treated as an incomplete gift for federal gift tax purposes and does not trigger gift tax upon its creation; and

(c) The settlor does not retain any power that would cause the trust to be treated as a "grantor" trust for income tax purposes, such that the trust, and not the settlor, is taxed on the income of the trust.

(3) In a series of private letter rulings, the IRS has confirmed that a trust may be established where the grantor parts with sufficient control such that the settlor is not treated as the grantor for federal income tax purposes, but where the settlor retains sufficient control so that the gift is deemed to be incomplete for federal gift tax purposes.

(4) The DING or NING trust offers no savings from federal income tax, because the trust still must pay federal income tax on any income.

(5) However, the trust can offer savings from state income tax, because the trust is designed to be treated as a resident only of the forum state, and the trust would pay no income tax in that state.

(6) Generally, New York taxes "Resident Trusts" on income, regardless of whether that income comes from sources located in New York.

(7) New York's Response to DING/NING Trusts

(a) New York law generally defines a "Resident Trust" as:

(b) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or

(c) a trust, or portion of a trust, consisting of the property of:

> "(i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or

> (ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable."

(d) New York law provides, however, that even if a trust is created by a New York resident as provided above, a Resident Trust is not subject to tax if all of the following are satisfied:

> "(i) all the trustees are domiciled in a state other than New York;
>
> (ii) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and
>
> (iii) all income and gains of the trust are derived from or connected with sources outside of the state of New York."

(e) Prior Law and DING/NING Trusts by New York Resident. Under prior law, if a trust was created by a New York resident, but has no New York resident trustee, no assets located in New York, and no New York source income, then the trust pays no New York income tax. This tax savings can be considerable. Currently, New York has a state capital gains rate of 8.8%.

(f) Current Law and DING/NING Trusts by New York Residents. However, in 2014 New York adopted a statute to expressly address such DING/NING trusts. This law classifies such DING/NING trusts as grantor trusts for purposes of New York state law. This law provides that a trust is treated as a Resident Trust if the grantor is a New York resident, if the transferor is not treated as grantor for federal tax purposes, and if the transfer to the trust is an incomplete gift for federal gift tax purposes. The statute taxes in New York the assets of an "incomplete gift non-grantor trust," which is defined as follows:

> an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under … the Internal Revenue Code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under … the Internal Revenue Code, and the regulations thereunder.

That is, the statute expressly reaches trusts which (1) are non-grantor trust for federal income tax purposes, and (2) result from an incomplete gift for federal income tax purposes.

I. Charitable Planning

1. Many opportunities exist for enhanced charitable giving by trust and private banking customers. This is especially true when one examines the history of charitable giving by Americans.

   a. Americans are among the most generous people, ranking second only to Canadians in terms of average donations to charity.

   b. In 2016, Americans gave $390.05 billion to charities. This was a $10.16 billion increase over charitable giving in 2015 (Giving USA 2017: The Annual Report on Philanthropy for the Year 2016, published by Giving USA Foundation, and researched and written by the Center on Philanthropy at Indiana University).

   c. Individuals gave $281.86 billion and contributed 72¢ of each dollar given to charity in 2016.

   d. Bequests totaled $30.36 billion in 2016.

   e. Corporate giving was $18.55 billion in 2016.

   f. Far more than one million charities are presently recognized by the IRS.

2. Given the generosity of individuals, coupled with the overwhelming value of the future transfer of wealth between generations, many opportunities will exist for charitable planning no matter what happens in the future,

3. Income Tax Deduction for Charitable Contributions. The deductibility of charitable contributions for income tax purposes is subject to two types of limitations. These two limitations often make charitable planning challenging.

a. Percentage Limitations. There are “percentage limitations” on the amount that an individual may claim as a charitable deduction against his gross income in any tax year.

b. Valuation Limitations. With respect to certain appreciated property contributed to charity, the individual may be required to use the property’s tax basis, rather than its fair market value at the time of the contribution, for the purpose of determining the deductible amount of the contribution.

4. Substantiation Requirements. The IRS may disallow an individual’s income tax charitable deduction if it is not properly substantiated. Recordkeeping requirements apply to all charitable contributions. Additional appraisal requirements apply to certain large contributions of property, other than cash or publicly traded securities. Additionally, the Act eliminates the statutory provision that excuses a donor from obtaining a contemporaneous written acknowledgement of a charitable gift if the donee organization files a return with the required information.

5. Split interest charitable gifts, especially lifetime charitable remainder trusts (which provide an income tax charitable deduction for the remainder interest), will continue to be used if there is no estate tax. If the estate tax is ever repealed, but the gift tax is not, charitable lead trusts, especially charitable lead annuity trusts which can be “zeroed out,” will be popular.

6. High worth clients will need advice on setting up private foundations with all of their restrictions and limitations and donor advised funds.

7. Planning for charitable gifts from IRAs in lieu of minimum required distributions will continue.

J. Retirement Benefits

1. For all estate planning professionals who represent and work with executives, business owners, and self-employed professionals, planning for retirement benefits is critical.

2. Retirement benefits will be the single largest asset of many individuals. It is common for retirement benefits to have a value in the hundreds of thousands of dollars, and benefits exceeding one million dollars are by no means rare. Ownership and receipt of retirement benefits will entail significant income tax consequences even if there is no estate tax.

3. Given the complexity of retirement plans, clients need advice in navigating the distinctions between qualified and non-qualified benefits and understanding the differences between, for example, defined benefit and defined contribution plans and regular IRA’s and Roth IRAs.

K. Elder Law

1. Estate planning for the elderly and incapacitated presents unique challenges. On the non-tax front, there may be questions of the individual's competence, or ability to understand the estate planning alternatives being considered. Communication may be a challenge due to physical disability. There may be questions of influence by other family members.

2. Elderly clients often have special concerns related to health care and extended care arrangements for themselves.

3. If the person is mentally incapacitated, and needs estate planning, there are both special procedures and special challenges in determining the person's presumed intent.

4. As the American population ages, more and more people will need advice on issues such as financial planning, housing, long-term care insurance, Medicare, and Medicaid.

L. Business Planning

1. Advising closely held businesses on non-tax and tax issues will continue to be important even if few people are subject to the estate tax.

2. Non-Tax Issues

a. Experts estimate that 85% of the crises faced by family businesses focus around the issue of succession. Therefore, in addition to addressing the legal aspects of passing a family business from one generation to the next, attorneys, accountants, family business consultants, trust officers, and other professionals must help families meet and overcome the conflict that will inevitably occur when a family plans for the succession of the control and/or ownership. In fact, such conflict is, in most situations, inescapable. Experts tell us that conflict is a necessary part of human relationships. Human beings are incapable of spending any significant time together without having differences.

b. Surmounting the challenges of this conflict requires both sensitivity to family dynamics and an extensive knowledge of the wide range of legal disciplines that impact succession issues.

c. Lack of Succession Planning.

(1) Despite the importance of succession planning, a 2007 survey of family businesses found that 40.3% of business owners expected to retire within 10 years.

(2) But of those business owners expecting to retire in 5 years, only about half (45.5%) had selected a successor, and of those expecting to retire in 6–11 years, only 29% had selected a successor. But 30.5% had no plans to retire, ever; and since the median age of the business owner was 51, many planned to die in office.

d. Human Planning Requirements.

(1) A business owner who fails to prepare and execute a succession plan—and especially one who dies in office—leaves his or her family, business, and wealth in a uncertain state.

(2) The business will be subject to questions about what should be done with the business, and attacks by those who wish to take control or have ownership or those who think that they are entitled to ownership and control.

3. Planners will have to advise closely-held and family-owned businesses on a variety of other issues as well, including the following:

a. Buy-Sell Agreements

b. Redemptions of Stock under Section 302 of the Internal Revenue Code

4. S Corporations. Much planning will have to be done for S Corporations. There are over 3.5 million S Corporations. Many taxpayers will want to revisit the “S Corporation versus C Corporation” analysis.

M. Trust Administration and Fiduciary Litigation

1. A doubled estate tax exemption level may mean that individuals will place more assets and funds in trust than currently, because assets will no longer be depleted to pay estate, gift, and generation-skipping transfer taxes. The more assets that are in trust, the more likely that beneficiaries will fight with themselves or contest the actions of trustees. Thus, more trusts will likely lead to more fiduciary litigation than currently.

a. With the rise of the use of irrevocable trusts for tax and non-tax reasons, draftspersons and settlors are looking ways to provide for flexibility in these irrevocable trusts. There will be a growing need for advice on this. Methods that are used include:

(1) Lifetime and testamentary powers of appointment.

(2) The use of trust directors or protectors who have powers to amend the provisions of irrevocable trusts.

(3) Trust reformations.

(4) Non-Judicial Settlement Agreements under the Uniform Trust Code.

(5) Trust mergers.

(6) Trust divisions.

b. An increase in fiduciary litigation or fiduciary disputes could lead to more work for estate planning professionals as expert witnesses, mediators, or arbitrators.

c. In addition, an increase in the amount of assets held in trust could result in the need for more investment advice with respect to the appropriate assets to be held in particular trusts.

N. Mediation or Arbitration

1. Mediation of disputes which is non-binding or arbitration of disputes which is binding may be a way of resolving disputes involving trusts.

2. The trust instrument might simply provide that in the event of disagreement between two individuals—such as a disagreement between two trustees, or a disagreement in a valuation of trust property that might affect two beneficiaries—those individuals must submit the dispute to a third party, whose determination is binding.

O. Decanting. This is a technique under which a trustee of a current trust may create a new trust and transfer assets to the new trust. Given the differences between the law of the different states that permit decanting either by case law or statute, advice will be needed on decanting. The Uniform Trust Decanting Act ("UTDA") was promulgated by the Uniform Law Commission in 2015. The purpose was to provide a more complete set of rules for decanting than currently exist in any state. The UTDA has, as of January 1, 2018, been enacted in five states: Colorado, New Mexico, North Carolina, Virginia, and Washington.

1. Decanting Statutes. As of January 2, 2018, twenty-six states now have statutes under which a trustee, pursuant to a power to distribute trust assets outright, may appoint trust assets in favor of another trust. These states are the following:

1. Alaska

2. Arizona

3. Colorado
4. Delaware
5. Florida
6. Illinois
7. Indiana
8. Kentucky
9. Michigan
10. Minnesota
11. Missouri
12. Nevada
13. New Hampshire
14. New Mexico
15. New York
16. North Carolina
17. Ohio
18. Rhode Island
19. South Carolina
20. South Dakota
21. Tennessee
22. Texas
23. Virginia
24. Washington
25. Wisconsin
26. Wyoming

II. Traditional Planning for Clients

A. Even with the doubling of the estate tax exemption, many clients will still have to engage in planning to avoid estate, gift, and generation-skipping transfer tax planning. In advising clients on planning for estate, gift, and generation-skipping transfer tax purposes, it is often best to start with the simpler techniques and move on to more complex techniques. Often, the simpler techniques produce the desired results without the need to use more sophisticated techniques. Various techniques are discussed below.

B. Annual exclusion gifts.

1. The gift tax law currently provides an exclusion from gift tax for the first $10,000 (indexed for inflation) given to any donee in any year (IRC § 2503(b)). The annual exclusion amount is indexed in $1,000 increments. The indexed amount in 2018 is $15,000.[3] Thus, in 2018, an individual to make annual gifts of up to $15,000 to any number of people, without any gift tax on the transfers. If the individual is married, the couple can each use their separate $15,000 exclusions, by either (a) using their separate funds to make gifts, or (b) using one spouse's funds and consenting to treat gifts made by the couple as being made one-half by each of the spouses (IRC § 2513).

2. The benefits that can be derived from making annual exclusion gifts should not be underestimated. In substantial estates, simple cash gifts of $15,000 made shortly before a decedent dies can generate a federal estate tax savings of up to $6,000 (or more if state estate taxes apply) for every transferee involved.

> **EXAMPLE:** Frank has extensive assets and three children (two of whom are married) and five grandchildren. If Frank has an estate that would be taxed in the 40 percent bracket (considering federal and state taxes), gifts of $15,000 to each of the three children, to the spouses of the two married children, and to each of the five grandchildren would entail transfers of $150,000. These transfers would result in an estate tax savings of $60,000. If Frank is married and his spouse joins in the gifts, an additional $150,000 (or a total of $300,000) could be transferred with no gift tax liability, and the total estate tax savings would be $120,000 per year. If Frank and his spouse continue this gift program for ten years,

[3] Although the IRS announced a $15,000 indexed annual exclusion prior to enactment of the Act, the indexing will have to be recomputed in light of the use of the chained CPI in place of CPI-U.

his taxable estate will be reduced by $3,000,000 and his estate tax would be reduced by $1,200,000.

3. By giving away property which is likely to grow in value, not only the gifted property itself, but all the future appreciation on that property can be removed from the donor's estate.

   EXAMPLE: Father gives Son $30,000 worth of stock in the XYZ Widget Company. No gift tax is owed because Father splits the gift with Mother. At Father's death, the $30,000 of XYZ Widget Company stock has soared in value to $150,000. If Father at his death is in the 40% estate tax bracket, the lifetime gift of the stock to Son saves $60,000 in federal estate tax.

4. The $15,000 annual exclusion is only available for gifts of present interests. Gifts of future interests, that is, gifts in which the donee's absolute, unrestricted right to enjoyment of the property is deferred until some future time, do not qualify. This means that many gifts in trust will not qualify for the annual exclusion unless the trust is properly structured.

   EXAMPLE: An individual sets up a trust for his twenty-five-year-old son which provides that the trustee has the discretionary power to distribute income and principal to the son for five years, and at the end of the five years the property will be distributed outright to the son. The gift is a future interest since the son's unrestricted right to beneficial enjoyment of the property is deferred for five years. This transfer would not be eligible for the $15,000 annual exclusion. Minor exclusion trusts and Crummey trusts can be used to qualify gifts in trust for the annual exclusion.

C. Dynasty trusts and use of GST exemption.

1. The generation-skipping transfer tax ("GST tax") has made it more difficult to plan effectively for future generations. The purpose of the GST tax is to require that estate tax (or its equivalent) be paid at each generation. When one considers the fact that the total of the estate tax on a parent's and a child's estates could consume 80% of an asset's value by the time it gets to a grandchild, this concept can be devastating to a family's wealth.

2. There is a very important exception to the GST tax. Every individual has a $10,000,000 GST exemption (adjusted for inflation) that can be used to shield transfers from the tax. A husband and wife have a combined exemption of $20,000,000 (adjusted for inflation). The ability to apply this exemption to property and have that property and all future appreciation

protected from transfer tax can provide substantial benefits to future generations.

3. Individuals with significant wealth should try to take advantage of the GST exemption during life by setting aside property in an irrevocable trust for children and grandchildren. The sooner the GST exemption is used, the greater the amount of property that will be sheltered from transfer tax. With the doubling of the gift tax and GST exemptions in 2018, clients who are or may be in a taxable estate situation and who can afford to should make gifts now to take advantage of the new exemption and get the future appreciation out of their estates. This would also protect them from future changes in the estate, gift, and generation-skipping taxes. In addition, under current law, the doubled exemption will sunset as of January 1, 2026. Moreover, during the period before 2026, the control of Congress and/or the White House could change and the provisions enacted in the Act could be reversed or modified to the detriment of taxpayers.

4. An individual or couple can get a substantial head start on the use of the GST exemption with a gift using the full gift tax applicable exclusion amount.

> **EXAMPLE:** A husband and wife give $10,000,000 to an irrevocable trust for the benefit of their descendants and allocate their GST exemptions to the trust. If the trust assets grow on average at a 6% after tax rate (accumulated income plus appreciation) and husband and wife live for another 25 years, there will be over $42.9 million in the trust at their deaths. By creating the trust during life, the couple has set aside an additional $32.9 million that can pass tax-free to grandchildren.

5. Another way to maximize the use of the GST exemption is to create a so-called "dynasty trust" that is intended to last for the maximum period permitted by law. Under many states' laws, a dynasty trust can last for up to 21 years after the death of the last surviving family member who was living when the trust was created (this period of time is called the "perpetuities period"). Assuming normal life expectancies, such a trust created by an individual today could be expected to last nearly 100 years. A number of states now permit perpetual trust terms, and one can take advantage of this by choosing which state's law will govern the trust. During the existence of the trust, trust property would be available to the grantor's descendants for such purposes as the grantor designates. There would be no gift, estate or GST tax assessed on the trust property during the term of the trust. Thus, the property can be insulated from transfer tax for two or three generations, and sometimes in perpetuity if desired.

> **EXAMPLE:** A husband and wife place $10,000,000 in a dynasty trust for the benefit of their descendants, and allocate their GST exemptions to the trust. The trust is to last until the end of the perpetuities period, assumed to occur in 100 years. Assuming the trust assets grow on average at a compounded 6% after tax rate and 2% per year is paid out to the beneficiaries, the assets will be worth $505 million when the trust ends in 100 years. This property will pass to their grandchildren or great-grandchildren free of transfer tax at that time.

Assume that the assets grow at the same rate but the trust is not exempt from the GST tax because no GST exemption was allocated to it. Assume that a 40% GST tax is imposed in 80 years when the grantor's last child dies. At the child's death in 80 years, the assets will have grown in value to $230.5 million. However, a GST tax of about $92.2 million will be due, leaving about $138.3 million after tax. At the end of an additional 20 years, the trust will be worth $303 million, or $202 million less than if it had initially been exempted from GST tax.

6. One variation on the use of the dynasty trust for married clients who would like to give away assets now to their children and grandchildren and others now but worry about possibly needing access to the funds later is for one spouse to create a SLAT or "Spousal Lifetime Access Trust" which is nothing more than an irrevocable trust funded with gifts using the applicable exclusion with the grantor's spouse as a discretionary beneficiary. It is also possible for each spouse to create a dynasty trust for the benefit of the other spouse and the descendants or other beneficiaries, but care needs to be taken to avoid the application of the reciprocal trust doctrine.

7. For single individuals who wish to make large gifts to a dynasty trust while retaining access to the assets in the trust, one possibility is a Domestic Asset Protection Trust under the laws of one of the eighteen states that now permit them. Several commentators have taken the position that if creditors cannot reach the trust property, as will be the case if the Domestic Asset Protection Trust statutes prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. Instead, a completed gift will occur upon the transfer of the property to the Domestic Protection Trust. The result is a freeze transaction. The settlor would incur gift tax (or use exemption) upon funding of the trust and would continue to enjoy the property as a discretionary beneficiary of the trust; however, the trust would not be taxed in the settlor's estate under either Internal Revenue Code Sections 2036(a)(1) or 2038. The donor could use part or all of his or her $10 million gift tax applicable exclusion amount to shelter the gift from gift tax.

> **EXAMPLE:** A creates a Domestic Protection Trust in Delaware in 2018 and funds it with $10 million. This gift escapes gift tax because it is sheltered from gift tax by A's lifetime $10 million exclusion from gift tax. A and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. A dies in 2025 when the assets in the trust are worth $ 22 million. Up until the time of his death, A has been a discretionary beneficiary and received distributions from the trust. By using a Domestic Protection Trust, according to its proponents, the $12 million of appreciation after funding of the trust will escape estate taxation.

In order to obtain this favorable tax treatment, there first must be a completed gift for purposes of Internal Revenue Code Section 2511. To have a completed gift, the settlor's creditors should not be able to look to the settlor's Domestic Protection Trust for payment of debts.[4] A gift should become complete when the period specified under the law of the jurisdiction for a creditor to reach the property in the trust ends. Note that this period is typically a few years under state law, so this technique would best be used well before 2026.

8. Advisors should also consider using outright gifts of life insurance or irrevocable life insurance trusts as a method to leverage the increased exemption to provide more for family members and others.

D. Portability of Estate Tax Applicable Exclusion Amount

1. Portability of the federal exclusion provides further planning options. Using "portability," spouses can effectively combine their estate and gift tax exemptions, no matter how the assets pass upon the first spouse's death. This would enable spouses to pass a total of $20,000,000, indexed for inflation, free of estate and gift tax.

2. As an example, a couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $11,180,000 of exclusion based on the death of the first spouse in 2018. The surviving spouse would then be able to use the unused exemption of the first spouse, either for inter vivos gifts during the life of the second spouse, or upon the second spouse's death.

[4] Comm'r v. Vander Weele, 254 F.2d 895 (6th Cir. 1958); Outwin v. Comm'r, 76 T.C. 153 (1981); Estate of Paxton v. Comm'r, 86 T.C. 785 (1986).

3. To apply the portability rules, the legislation in 2010 introduced the term “deceased spousal unused exclusion amount,” or “DSUE amount”.

4. The executor of the deceased spouse’s estate must elect to allow the surviving spouse to use the DSUE amount. This means that the estate of the deceased spouse will need to file an estate tax return, even if it is below the threshold for filing.

5. The DSUE amount available to the surviving spouse is limited to the lesser of the basic applicable exclusion amount and the unused exclusion amount of the last deceased spouse.

6. The DSUE amount can be used by the surviving spouse to make taxable gifts. Temporary regulations provide that a surviving spouse will be deemed to use DSUE amount first when making taxable gifts.

7. However, portability has some limitations over traditional planning that would make use of the first spouse’s estate tax exemption, including the following:

   a. There is no portability of GST tax exemption.

   b. The DSUE amount is not indexed for inflation.

E. Grantor Retained Annuity Trusts

1. A GRAT is an irrevocable trust in which the grantor retains the right to receive a fixed dollar amount annually for a set term of years. At the end of that period, any remaining property passes as provided in the trust, either outright to designated beneficiaries or in further trust for their benefit. For a GRAT to be successful, the grantor must survive the annuity term. If the granter dies during the term, the IRS includes the entire value of the GRAT in the grantor’s estate under Internal Revenue Code Section 2036 (retained interest) and Internal Revenue Code Section 2039 (right to an annuity). See, e.g., Letter Ruling 9345035 (Aug. 13, 1993).

2. The transfer of property to a GRAT constitutes a gift equal to the total value of the property transferred to the trust, less the value of the retained annuity interest. The value of the annuity interest is determined using the valuation tables under Section 7520 and the applicable interest rate for the month of the transfer. The grantor of a GRAT is treated as making an immediate gift when the trust is funded, but the value of the gift is a fraction of the total value of the property because it represents a future benefit. Therefore, if the grantor survives the annuity term, there is an opportunity for property to pass to the designated remaindermen at a reduced transfer tax value.

> **EXAMPLE:** Mary, age 55, transfers $500,000 of assets to a GRAT and retains the right to receive an annuity of $43,750 per year, payable annually, for 12 years. Under the IRS tables, if the Section 7520 rate is 2.2%, the value of Mary's retained annuity interest is $457,039, so the amount of the gift upon creating the GRAT is $42,961. (At 3.2%, the gift is $69,666.) If the trust assets provide an average return of at least 5% annually there will be $201,555 in the trust at the end of 12 years. That property will pass to the remaindermen for an initial gift of $42,961. If the trust assets provide an average return of at least 7% annually, there will be at least $343,475 in the GRAT at the end of the term.

3. The annuity does not have to be an equal amount each year. It can be defined as a fixed initial amount, increased by up to 20% in each subsequent year.

4. Most GRATs provide that the annuity payout amount must be satisfied from trust principal to the extent trust income in a given year is insufficient. The IRS has ruled privately that Internal Revenue Code Section 677 applies where the annuity may be satisfied out of trust income or principal. See e.g., Letter Ruling 9415012 (January 13, 1994). Therefore, virtually every GRAT should be treated as a grantor trust with respect to all trust income. This is an important additional benefit. It means that a GRAT can be funded with stock or partnership interests or real estate, and that asset can be paid back to the grantor to satisfy the annuity obligation without the distribution of the asset being treated as a sale.

F. Zeroed-Out GRATS. The GRAT is particularly attractive for individuals who have used their applicable exclusion amount but still want to transfer wealth to others. A "zeroed-out GRAT" can be used so that there are no gift tax consequences to the creation of the trust. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax. If the transferred assets increase significantly in value during the term of the GRAT, some of that appreciation is transferred out of the taxpayer's estate tax free.

1. Internal Revenue Code Section 2702 provides that an interest in a trust retained by the grantor will be valued at zero for purposes of determining the value of the gift to the trust, unless the retained interest is a qualified annuity interest, a qualified unitrust interest or a qualified remainder interest. The regulations under Internal Revenue Code Section 2702 provide that the term of the annuity or unitrust interest "must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods." Treas. Reg. § 25.2702-3(d)(3).

2. Despite the apparent statement in its own regulations granting three options for the term of a GRAT, the IRS took the position when it initially issued its final Internal Revenue Code Section 2702 regulations that an annuity payable for a term of years (with annuity payments continuing to the grantor's estate if he or she died during the term) always had to be valued as an annuity for a term of years or the prior death of the grantor.

   a. The position was not stated in the text of the final regulations; rather it was illustrated in one of the regulation's examples. See prior Treas. Reg. § 25.2702-3(e), Example 5.

   b. The requirement that one always must take into account the possibility of the grantor's death before the end of the term in valuing the annuity had the effect of reducing the value of the annuity, and increasing the value of the remainder interest and, therefore, the value of the gift for a transfer to a GRAT.

   c. Because of this and other requirements for valuing annuities, the IRS made it impossible to create an annuity in a GRAT with a value equal to the value of the property transferred.

3. In Walton v. Comm'r, 115 TC 589 (2000), the taxpayer challenged the position in the IRS regulations. The Tax Court agreed that Example 5 in the regulations is inconsistent with the purposes of the statute and declared the Example invalid.

   a. The case involved the widow of Sam Walton. In 1993, she transferred 7 million shares of Wal-Mart stock to two GRATs in which she retained an annuity of 59.22% for two years. If she died during the term, the annuity payments would continue to her estate. The GRATs failed to produce the desired benefits. The price of Wal-Mart stock remained essentially flat for two years, and all the stock was paid back to Mrs. Walton to satisfy the annuities.

   b. Mrs. Walton brought the suit to avoid a large gift tax liability for the failed transfer. Her annuity interests valued for the full two-year term resulted in a gift to the GRATs of about $6,195. If her annuity interest was valued as a right to receive payments for two years or her prior death, as the IRS asserted, the gift would be $3,821,522.

   c. The Tax Court first recognized that the IRS's regulations are entitled to considerable deference, but, as interpretative regulations, they still could be ruled invalid if they do not implement the congressional mandate in some reasonable manner. Based on the purpose of the statute and its legislative history, the court concluded that there was no rationale for requiring that the annuity be valued as a two-year or prior death annuity. In particular, the court noted that Congress referred to the charitable remainder trust rules as a basis for the Internal Revenue Code Section 2702 provisions, and the regulations clearly allowed a two-year term to be valued without prior death contingencies in a charitable remainder annuity trust.

d. The IRS subsequently amended its regulations to specifically recognize the valuation of term interests as term interests.

4. The ruling in Walton gave taxpayers the unique opportunity to implement a technique that has no tax cost if it fails. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax.

5. A zeroed-out GRAT often works best when the annuity term is short (such as two years) and the GRAT is funded with one stock. A single stock that performs well during a two-year period easily can grow at an annual rate of 20% or more over that time frame.

EXAMPLE: In February 2016 when the Section 7520 rate is 2.2%, an individual creates a two-year GRAT and funds it with $5,000,000 of stock that has a current price of $25 per share. He retains the right to receive an annuity of 51.6556% each year for the two years. The value of the annuity is $5,000,000, and the gift when the individual creates the trust is zero. If the stock increases to $30 per share after one year, and $36 per share at the end of two years (a 20% increase each year), there will be $1,517,884 left in the GRAT at the end of the two years to pass to children tax-free:

Initial Value of Stock:	$5,000,000
End Year 1 Value	$6,000,000
Annuity to Grantor:	($2,582,780)
Beginning Year 2 Value	$3,417,220
End Year 2 Value:	$4,100,664
Annuity to Grantor:	($2,582,780)
Property Remaining for Children:	$1,517,884

6. The property transferred to a two-year GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the grantor in the annuity payments. The grantor then can create a new GRAT.

7. If a short term GRAT is used, it is better to isolate separate stocks in separate trusts so that the losers do not pull down the winners.

8. The attributes of a zeroed-out GRAT fit well with closely held stock. The owner can use a GRAT to try to shift additional stock out of his or her estate, at no tax cost. Especially given the current Section 7520 rate, the stock does not have to grow at a tremendous rate for the GRAT to have some benefit. As long as the stock grows at a rate greater than the assumed IRS rate used in determining the gift, there will be some benefit.

> **EXAMPLE:** Mark is the owner of an increasingly successful business, Full Circuit, Inc. He has transferred some stock to his children using an irrevocable Crummey trust and has now fully used his gift tax applicable exclusion amount. After Mark funds the irrevocable trust, he transfers 4,200 of his remaining non-voting shares in Full Circuit to a 3-year GRAT. The stock is valued at $3,400 per share, so the total transfer is $14,280,000. The IRS Section 7520 rate in the month of the transfer is 3.0%. Mark retains an annuity of 29.2415% ($4,175,686) payable at the end of the first year, increased by 20% in each of years 2 and 3. The annuity has a value of $14,280,000, so no gift is made when Mark creates the GRAT. The stock increases in value to $3,600 per share after one year, $4,000 per share after two years, and $4,200 per share at the end of three years. The GRAT operates as follows:

Year-End	**Annuity Payable**	**Value Per Share**	**Shares Paid to Mark**	**Shares Remaining**
1	$4,175,686	$3,600	1,160	3,040
2	$5,010,823	$4,000	1,253	1,787
3	$6,012,988	$4,200	1,432	355

a. In this example, the GRAT removes 355 shares from Mark's estate, with a value of $1,491,000 at the end of the three-year term.

b. If the value of Full Circuit increases significantly over this time-period, the benefit of the GRAT is far greater. In effect, the GRAT allows Mark to shift most of this additional appreciation out of his estate.

> **EXAMPLE:** Assume the stock in Full Circuit increases in value by 15% in each of the first two years and 20% in the third year after Mark creates the GRAT. The GRAT operates as follows:

Year- **End**	**Annuity** **Payable**	**Value** **Per Share**	**Shares** **Paid to Mark**	**Shares** **Remaining**
1	$4,175,686	$3,910	1,068	3,132
2	$5,010,823	$4,495	1,115	2,017
3	$6,012,988	$5,395	1,115	902

c. In this example, Mark has moved 902 shares out of his estate, with a value of $4,866,290 at the end of the three-year term. Overall in this example, Mark's 4,200 shares originally transferred to the GRAT are worth $5,019,000 more after three years than in the prior example. The GRAT moves 97% of his additional appreciation ($4,866,290/$5,019,000) out of Mark's estate.

9. One issue in a straight-term-of-years, or Walton, GRAT is how to minimize the estate tax consequences if the grantor dies during the annuity term.

a. In a GRAT with annuity payable for a term of years or the grantor's prior death, if the grantor is married, the trust simply can provide that all the trust property will pass to a marital trust for the surviving spouse, or will pour back into the grantor's estate plan and be allocated between the marital and nonmarital trusts.

b. If the grantor dies during the term of a term-of-years GRAT, the annuity payments do not stop at the grantor's death; they are paid to the grantor's estate (or revocable trust if so designated in the GRAT). If the goal is to preserve the marital deduction for the property, the annuity payments should be bequeathed to the spouse or a marital trust under the grantor's estate plan, and the GRAT corpus at the end of the term should be paid to the spouse or marital trust. This should allow the two property interests to be merged back together, to qualify all the property for the marital deduction.

G. The GRAT can be a particularly advantageous way to transfer stock in an S corporation. An irrevocable grantor trust is a permissible shareholder of stock in an S corporation. See, e.g., Letter Ruling 9415012 (January 13, 1994). Because the S corporation is a flow-through entity for income tax purposes, the trustee of a GRAT is able to satisfy annuity payments with pre-tax dollars from the corporation. The same benefits exist for interests in a limited partnership or LLC.

> **EXAMPLE:** Carlos owns a 10% interest in an S Corporation that has an entity value of $27,500,000. After discounts, his interest is worth $2,000,000. He anticipates it will appreciate rapidly. Carlos transfers his $2,000,000 of S Corporation stock to a GRAT and retains an annuity of $200,000 per year for 12 years. The value of Carlos' retained annuity interest is $2,000,000, so Carlos makes no taxable gift when he creates the GRAT. The S Corporation currently

distributes cash of about $200,000 per year to Carlos (about 7.2% of the initial undiscounted value) to provide funds for income taxes and some additional discretionary shareholder funds. The GRAT can pay Carlos the annuity out of the cash distribution that the GRAT receives each year, and Carlos uses a portion of the annuity distribution to pay his income taxes related to the S Corporation income. The GRAT is able to retain all of the stock. If the value of the stock increases by about 5% per year, the GRAT will have $3,600,000 in it after 12 years.

H. If voting stock in a closely held corporation (one in which the grantor and related parties own 20 percent or more of the voting stock) is transferred to the GRAT, the grantor should not retain the right to vote that stock beyond the date that is three years before the end of the annuity term. The right to vote the stock will cause the stock to be included in the grantor's estate under Internal Revenue Code Section 2036(b), and the relinquishment of that right within three years of death will cause inclusion under Section 2035(d). If the grantor retains the right to vote the stock until the end of the annuity term, he must survive an additional three years to ensure that the property will be excluded from his estate. This problem can be avoided by using non-voting stock.

I. At the end of the annuity term, the property in the GRAT can be distributed outright to the grantor's children or other beneficiaries, or retained in trust. One advantage of retaining the property in trust is that the grantor's spouse can be a beneficiary, thereby permitting the couple to have some access to the property during the spouse's life and causing the trust to continue to be a grantor trust.

J. GRATs have a significant advantage over other gifting techniques because of the ability to define the retained interest as a percentage of the initial value of the gifted property "as finally determined for federal gift tax purposes". Thus, if the gift value is doubled, so is the retained annuity, and there is little or no increase in the amount of the gift.

K. Grantor Retained Unitrusts

1. In some circumstances, an individual may want to consider an alternative to a GRAT called the grantor retained unitrust (GRUT). In a GRUT, the individual retains the right to an annual payment equal to a fixed percentage of the value of the trust assets, determined annually.

2. Trust distributions to the grantor under a GRUT, unlike a GRAT, can vary from year to year, depending upon the value of the trust. The unitrust may be beneficial when the grantor is concerned about protection against inflation.

3. Offsetting the potential benefits of a GRUT is the fact that it may be more difficult to administer than a GRAT because the trust assets must be

revalued every year to calculate the distributable amount, and enough cash must be available to make any increased payments. This may be burdensome, especially if closely held stock is used to fund the trust. Increases in the value of closely held stock will require the GRUT to increase its payments even though it may not receive more income from the stock.

4. In addition, because the grantor under a GRUT will recover part of any appreciation and accumulated income in the trust, a GRUT often will leave the remainder beneficiaries economically worse off than if a GRAT were used.

5. It is also not possible to do a "zeroed-out GRUT" as it is possible to do a "zeroed-out GRAT." Planners therefore should carefully compare these two techniques before implementing one of them.

L. Charitable Lead Trusts

1. A charitable lead trust, or CLT, is sometimes used to try to accomplish the same benefits as a GRAT in situations where the client has a strong interest in also benefiting charity. With a CLT, the charitable beneficiaries receive a stated amount each year for a specified term of years or for the life or lives of an individual or individuals, and at the end of the period the remaining corpus is distributed to or in trust for the grantor's descendants or other noncharitable beneficiaries.

2. As with charitable remainder trusts, lead trusts may be one of two types--either an annuity trust ("CLAT"), in which the charitable beneficiary receives a sum certain, or a unitrust ("CLUT"), in which the charity receives a fixed percentage of the value of the trust property. The lead trust is very flexible; it may allow the trustee discretion in determining which charities will receive payments, or it can provide for specific charities. Unlike a charitable remainder trust, there is no minimum payout for a charitable lead trust, and it can be for any term of years. The trust may be created irrevocably during life or at death.

3. Upon creating the trust, the grantor makes a gift to charity of the present value of the charity's right to receive trust payments. This gift qualifies for the federal gift tax charitable deduction. Generally, when the grantor creates the trust, he will not receive an income tax charitable deduction.

   a. One exception is where the CLT is a grantor trust, in which the trust income is taxable to the grantor under the applicable income tax rules. In this case, the grantor is entitled to claim an income tax charitable deduction in the taxable year in which the trust is created for the present value of the annuity interest.

b. The deduction will, however, be subject to a limitation of 30 percent of the grantor's contribution base (20 percent if long-term capital gain property is used to fund the trust) because contributions to a charitable lead trust are treated as "for the use of" the charitable donees. Treas. Reg. § 1.170A-8(a)(2).

c. In addition, the income of the trust in the years after its creation will be taxable to the grantor, with no further charitable deduction allowed, even though the trust actually distributes the income to charity.

4. If the CLT is not a grantor trust, the grantor will not receive any income tax charitable deduction for the amounts paid to charity, either when the trust is created or subsequently. However, the income generated by the trust's assets will be removed from the grantor's gross income. Thus, the income tax effect on the grantor will be equivalent to his receiving an income tax charitable deduction each year, but without the applicable percentage limitations for contributions.

5. A charitable non-grantor lead trust is not exempt from taxation, and the trustee must file a fiduciary income tax return (Form 1041) each year. However, the trust's taxable income should be low or nil in most cases, since the trust will receive a charitable deduction for the payments made to charity. IRC § 642(c)(1). Any income the trust earns in excess of the yearly annuity amount will be taxed to the trust at its separate rates.

6. The trust will be entitled to a charitable deduction only for amounts paid for charitable purposes from gross income. IRC § 642(c)(1). To maximize the trust's income tax charitable deduction, therefore, the charitable payments should be made as much as possible from trust income, before trust principal is used.

7. Lifetime Transfer Tax Planning Opportunities

a. A grantor CLT may be attractive because it allows the donor to claim a large up-front charitable income tax deduction, with the prospect for some transfer tax benefits at the end of the charitable term, as described below. An individual who has a significant income event in one year may be interested in a grantor CLT.

b. The primary appeal of a CLT is the potential transfer tax benefit that can be obtained while fulfilling pre-existing charitable giving goals. A CLAT can be structured so that the value of the remainder interest is zero like a zeroed-out GRAT.

> **EXAMPLE:** If an individual transfers $1,000,000 to a CLAT to pay one or more charities a $83,770 annuity each year for 15 years, and the Section 7520

rate at the time is 3%, the annuity interest will be valued at $1,000,000 for gift tax purposes, and the trust remainder will be zero. If the trust earns 5%, then $271,290 will remain at the end of the term and will pass to the remainder beneficiary at the end of the annuity term free of gift tax. If the trust earns 7% annually, almost $654,000 will remain after 15 years.

8. Testamentary Tax Planning Opportunities

a. In addition to an inter vivos transfer, one can create a CLT to take effect at death. A testamentary CLT can be used to reduce federal estate tax that otherwise will occur at the testator's death. The testator's estate may claim a federal estate tax deduction for the value of the charitable interest, and, as is true of the inter vivos transfer, only the remainder will be subject to transfer tax.

b. The testamentary CLT provides no income tax benefit to the testator or the noncharitable beneficiaries. While it can be used to reduce the estate tax cost of transferring assets to those beneficiaries at death, this fact does not necessarily leave those beneficiaries better off than if the trust assets passed directly to them at the decedent's death with no charitable deduction. This is because use of a CLT postpones the time at which the noncharitable beneficiaries come into possession of the trust assets. The lost use of the trust assets by those beneficiaries during the charitable term is a significant detriment, which can outweigh the estate tax savings from using the trust.

(1) For example, assume Decedent A leaves $2 million in a trust for descendants. It accumulates income for 20 years and then distributes to descendants. Its total return during the period averages 6% per year. After 20 years, the trust has $5,971,968.

(2) Decedent B leaves $5,425,000 in a CLUT that pays a 5% unitrust amount to charity for 20 years, and then distributes to descendants. The value of remainder interest in B's estate is $2 million. The trust earns 6% per year on average. After 20 years, the trust has $6,425,600.

(3) Because the return on the trust property exceeded the 5% payout rate, more property accumulated for the children through use of the CLUT. However, the difference is not significant, and it is at a cost of deferring any access to the property for 20 years. (With an ordinary trust for descendants, discretionary distributions could be made

during the 20-year period.) If the trust property earned only 4% per year on average, the trust for descendants would have $4,382,200 after 20 years, and the CLUT would have only $4,348,360.

c. An individual considering a testamentary CLT may be willing to accept this possible detriment to his family because of his or her significant charitable intentions, and if the trust serves the additional purpose of reducing the chance that the IRS will challenge valuations in the estate. It is possible to couple a testamentary CLT with a residuary bequest that caps the taxable value of the estate (often called a "charitable cap").

(1) For example, an individual could have a residuary provision, after various specific bequests to individuals and trusts for family, that states that the trustee will allocate the remaining trust principal to a charitable lead annuity trust or unitrust with a 15-year term and the minimum payout rate necessary so that the taxable value of the disposition does not exceed $10 million.

(2) If the residuary assets are valued at $30 million, a CLUT would need to have a unitrust payment of 7.26%. The CLUT would make charitable payments starting at about $2,178,000 per year. After 15 years, the property would pass to descendants or trusts for their benefit. Even if the CLUT averages a return of only 4% per year, there still would be $17,840,000 remaining at 15 years. If the average investment return was 8%, the CLUT would have over $32 million after 15 years.

(3) If the IRS challenged the value of certain assets in the individual's estate, the change in value only would alter the percentage payout on the CLUT. For example, if the IRS claimed the estate was worth another $5 million, the CLUT payout rate would adjust to 8.234%, and the taxable value would remain at $10 million. The IRS loses all incentive to challenge valuations.

M. Generation-Skipping Tax Planning With CLTs

1. The goal of many clients is to pack as much property into a trust as is permitted within the confines of their available GST exemptions. For these clients, the use of lifetime gifts to start GST exempt trusts growing immediately is only a starting point.

2. Leveraging GST Exemption With CLT

a. Because the value of a charitable interest can be deducted from the denominator of the applicable fraction that applies to a trust under chapter 13 of the Internal Revenue Code, it clearly was possible under the original chapter 13 provisions to "leverage" the use of a transferor's GST exemption by creating a CLT.

b. Congress partially closed this perceived loophole by enacting special rules for calculating the applicable fraction for CLATs, effective for trusts created after October 13, 1987.

(1) Internal Revenue Code Section 2642(e) provides that the applicable fraction for a CLAT shall be a fraction whose numerator is the "adjusted GST exemption" and whose denominator is the value of the trust property immediately after the termination of the charitable interest.

(2) The "adjusted GST exemption" is defined as an amount equal to the GST exemption allocated to the trust when it is created, compounded annually over the charitable term at the interest rate used to determine the value of the charitable interest under the applicable valuation tables.

> **EXAMPLE:** An individual creates a $1 million CLAT trust to pay an annual annuity of $80,000 to charity for 10 years, and to pay the trust principal remaining at the end of that period to his grandchildren. Assume that the Section 7520 rate used to value the transfer is 4%. Under the valuation tables, the gift tax value of the charitable gift is $648,870, and the gift tax value of the remainder is $351,130. If the individual allocates $351,130 of GST exemption to the trust, the adjusted GST exemption at the end of the annuity term would be $519,760 ($351,130 compounded at 4% annually for 10 years).

If the value of the trust principal at the end of the charitable term does not exceed the adjusted GST exemption, the trust will be entirely sheltered from GST tax, and there will be no tax when the property passes to the grandchildren.

However, if the trust principal has remained at $1 million, or has appreciated to a greater amount, then the trust will not be entirely GST exempt. If the individual is still living at that time and has sufficient additional GST exemption left, he could make an additional allocation of GST exemption to the trust and avoid the shortfall. Otherwise, GST tax will be incurred when the charitable term expires.

(3) If the trust principal is worth less than the adjusted GST exemption when the charitable term expires, then the transferor will have allocated too much GST exemption to the trust. There is no way to recover any excess exemption allocated to the trust in such a case. Treas. Reg. § 26.2642-3(b).

(4) The GST regulations provide that formula allocations made with respect to CLATs are not valid except to the extent they are dependent on values as finally determined for federal transfer tax purposes. Treas. Reg. § 26.2632-1(b)(2). This would appear to foreclose the possibility of using a formula that provides that the creator of the charitable lead annuity trust is allocating the least amount of GST exemption necessary to give the trust a zero inclusion ratio.

(5) As a result, determining the amount of GST exemption to allocate to a CLAT in many cases may become a guessing game. However, if the value of the trust principal at the end of the charitable term can be reasonably ascertained at the time the trust is established, it should be possible to make the correct allocation of GST exemption to the trust at the outset, and properly leverage the exemption.

> **EXAMPLE:** An individual purchases a ten-year bond with a face value at maturity of $1 million and an annual coupon rate of 5%, and transfers the bond to a new, ten-year CLAT. The interests transferred are valued using a 4% interest rate. The trust will pay an annual annuity of $50,000 to charity, and will pass to the individual's grandchild at the end of the annuity term. If the individual allocated $675,564 of GST exemption to the trust (representing the present value of $1 million in ten years discounted at 4%), the adjusted GST exemption will be $1 million at the end of the charitable term, and the trust should be completely sheltered from GST tax.

c. CLUTs are not affected by Internal Revenue Code Section 2642(e), and the general rules under Internal Revenue Code Section 2642(a) continue to apply to them. This means that it is possible to leverage GST exemption against the remainder interest in a CLUT as before to produce an inclusion ratio of zero.

N. Sale of Remainder Interest in a GRAT or CLAT

1. An individual can avoid the ETIP rules or CLAT rules by setting up a GRAT or CLAT to permit a sale of a remainder interest in the trust to another trust that is already exempt from generation-skipping tax. For example, a GRAT could be drafted to vest the remainder interest in the grantor's children. It also could allow for the transfer of the interests to a third party (that is, no spendthrift restriction). Upon formation of the GRAT, the remainder interest would have a relatively low value. The children then could sell that interest to a previously created irrevocable trust for the grantor's descendants that is exempt from GST tax. When the GRAT terminates, the remaining trust property will be distributed to the exempt trust.

> **EXAMPLE:** P funds a 15-year GRAT with $2,000,000 of property and retains an annuity of $200,000 per year. The value of the gift of the remainder interest under the IRS valuation tables is $300,000. The GRAT provides that at the end of the term, if P is living, the GRAT property will be distributed in equal shares to P's three children, and any deceased child's share is payable to the child's estate. P's husband predeceased P and a $1,000,000 GST trust was created at his death. Shortly after the GRAT is created, the trustees of the GST trust purchase the remainder interest in the GRAT from the children for $300,000. At the end of 15 years, the GST trust receives the remaining assets of the GRAT, which should be fully GST exempt because they were acquired for full and adequate consideration.

2. The sale of a remainder interest in a GRAT or a CLAT may have income tax consequence to the selling remaindermen. The GRAT or CLAT will have a uniform basis in the transferred property equal to the basis in the hands of the grantor (adjusted for gift tax paid, if any). The remaindermen are treated as having a proportionate share of that basis for the purpose of determining gain if the remainder interest is sold.

> **EXAMPLE:** Assume the $2,000,000 of assets transferred to the GRAT have an aggregate basis of $1,000,000. The remainder interest represents about 15% of the value in the trust ($300,000/$2,000,000) so the remaindermen have 15% of the basis, or $150,000. If the children sell the remainder interest in the GRAT to a GST trust, they would recognize gain of $150,000 ($300,000-$150,000).

If the GRAT is funded with cash, and the remainder interest is sold shortly after the trust is funded, the remaindermen should recognize little or no gain.

3. The GST trust that acquired the remainder interest takes a basis in it equal to what it paid. For instance, the GST trust in the example above will have a basis in the remainder interest of $300,000.

   a. When the GRAT terminates, the GST trust probably should take a basis in the assets it receives equal to its basis in the remainder interest. It thereafter would recognize gain (or loss) as assets are sold. Therefore, there is an income tax detriment to this technique.

   b. If the distribution upon termination of the GRAT is in the form of cash, the GST trust probably would recognize gain immediately to the extent the cash exceeded its basis.

4. One risk inherent in this transaction, if it is done with a GRAT, is that the grantor may die during the annuity term. If this occurs, the GRAT property will be included in the grantor's estate. Some GRATs are drafted to provide a reversion back to the grantor's estate in this case.

   a. If a sale of the remainder interest in the GRAT is contemplated, the planner should consider not having a reversion in the GRAT. A reversion would result in the GST trust receiving no property if the grantor dies during the term.

   b. Even without a reversion, it is not clear how the IRS would treat inclusion of the GRAT property in the grantor's estate. The IRS could view it as a new transfer and take the position that the property passing to the GST trust from the GRAT is not GST exempt, even though it was purchased with GST exempt assets.

O. Gift of Remainder Interest in a GRAT or CLAT

1. As described above, two of the drawbacks of a sale of remainder interest in a CLAT or GRAT are the possible capital gain incurred at the time of the sale and the limited tax basis that the purchasing trust may have in assets received as a result of buying the remainder interest.

2. To avoid these income tax consequences, the holders of the remainder interest could make a gift of the remainder interest rather than selling it.

> **EXAMPLE:** P funds a 15-year GRAT with $2,000,000 of property and retains an annuity of $200,000 per year. The value of the gift of the remainder interest under the IRS valuation tables is $300,000. The GRAT provides that at the end of the term, if P is living, the GRAT property will be distributed in equal shares to P's three children, and any

deceased child's share is payable to the child's estate. Each child makes a gift of his or her share of the remainder interest to an irrevocable trust created by the child. Each gift uses $100,000 of the child applicable exclusion amount. The child allocates $100,000 of GST exemption to the trust. If, at the end of the 15-year term, the GRAT property is worth $1,800,000, each child's trust would receive $600,000 of assets.

3. In this example, a child is the transferor of the remainder interest in the GRAT. The remainder interest is not ETIP as to that child, because no part of the remainder interest would be included in the child's estate once he or she transfers it to the irrevocable trust. Therefore, the child should be able to allocate GST exemption to the remainder interest.

4. The planning goal in this alternative is to push the property down to grandchildren or more remote descendants of the grantor of the GRAT. A child of the grantor cannot have an interest in the irrevocable trust to which he or she gives the remainder interest. However, the child's spouse could be a discretionary beneficiary of the trust. In addition, it should be possible for the child to make a gift of less than all of his or her remainder interest. For example, the child could give one-half of the remainder interest to the irrevocable trust and retain the other one-half.

5. A gift of a remainder interest in a GRAT does entail the same risks and uncertainties as a sale should the grantor die during the GRAT term. The GRAT should not provide for a reversion to the grantor in that case, for it would cause the child to waste both applicable exclusion amount and GST exemption. In addition, there is the risk that the IRS could view inclusion in the grantor's estate as a new transfer of the remainder interest and treat the property passing to the child's irrevocable trust as not GST exempt.

6. In Letter Ruling 200107015 (February 16, 2001), the IRS recharacterized a transaction involving a gift of a remainder interest and treated some of the property at the end of the annuity term as not GST exempt.

   a. In that ruling, the taxpayer proposed that an existing CLAT be modified pursuant to a special reserved power in the instrument to give one remainder beneficiary a vested remainder interest. The child who was the remainder beneficiary then proposed to make a gift of his remainder interest to his children.

   b. The IRS stated that these acts would unfairly circumvent congressional intent in limiting the ability of taxpayers to allocate GST exemption to a CLAT. Therefore, the IRS ruled that it would treat only the current value of the remainder interest as being transferred by the child. All other property passing to the child's children on termination of the annuity term would be treated as a generation-skipping transfer by the original grantor.

c. There is no regulatory or statutory authority to suggest that a remainder interest that is a separately alienable property interest should be valued differently for generation-skipping tax purposes than for gift tax purposes when the child transfers it.

d. It is especially difficult to defend the IRS's position if the child sells the remainder interest rather than transfers it by gift. In that case, the generation-skipping trust acquires the asset for full and adequate consideration, as determined under the IRS's own valuation tables and statutory requirements. If a child receives an asset at the termination of a trust, and then transfers it to a grandchild pursuant to a pre-existing contractual obligation, entered into for full and adequate consideration, there appears to be no legal justification for recharacterizing the transfer as coming from the child's parent.

P. Sale to "Intentionally Defective" Grantor Trust

1. The sale to an "Intentionally Defective" Grantor Trust (that is a trust purposefully made a grantor trust) combines the long-recognized advantages of a sale in exchange for a promissory note with the benefits of a grantor trust.

a. An installment sale involves the sale of a business interest or other assets by an individual to the business or a third party in exchange for an installment obligation (e.g., a promissory note). The sale limits the value of the individual's retained interest to the amount of any down payment plus the face value of the note (or other evidence of indebtedness) received, reduced by the income tax liability on the payments made to him. A market rate of interest must be paid on the installment obligation in order to avoid having the face value of the note discounted for tax purposes and a gift imputed. However, the AFR should be considered a market rate for this purpose, for the reasons previously discussed. This is advantageous to the taxpayer since the AFR is usually lower than commercial lending rates.

b. Any gain from an installment sale of an asset is generally reportable on a proportionate basis over the time period in which the payments are actually received, unless the individual elects otherwise. IRC § 453. Thus, income tax resulting from the gain can be deferred and spread over more than one year. Exceptions exist, such as if the property is sold within a certain period (generally two years) or if the repayment obligation is forgiven. If the individual dies before the obligation is paid in full, any unpaid principal balance is included in his estate, and the deferred gain is taxed as payments under the note and received by his beneficiaries. Finally, if the installment obligation is transferred by bequest or inheritance to the obligor or is canceled by the deceased seller's executor, the seller's estate will recognize any unreported gain. IRC § 453B.

c. Under Internal Revenue Code Section 453A, an interest charge is imposed on the capital gains tax deferred under such installment obligations to the extent the amount of such obligations held by the taxpayer resulting from sales in a single year have an aggregate face value which exceeds $5 million. The interest rate is the rate charged by the IRS for underpayment of tax.

2. The income tax detriment of the capital gain and the Internal Revenue Code Section 453A interest charge are often acceptable costs and an installment sale directly to children or to a non-grantor trust still makes sense. However, in most estate planning motivated transactions, the installment sale is made to an irrevocable grantor trust. The trust is not treated as a separate taxpayer for income tax purposes. As a result, the transaction is not treated as a sale for tax purposes and the resulting capital gain from the sale, and the interest charges, are eliminated.

> **EXAMPLE:** Carl creates an irrevocable gift trust and funds it with a gift of $1,000,000. The trust is structured as a grantor trust. Carl then sells a $5,000,000 asset to the trust for a 15-year installment note, bearing an interest rate of 2.62% (the February 2016 long-term AFR) with a balloon payment due at the end of the term. The trust asset produces a return of about 5% per year. The trust pays the interest of $131,000 each year. At the end of 15 years, the trust will have a value of $9,659,930, or $4,659,930 after repayment of the note.

3. There are several risks inherent in the sale to an IDGT:

a. Valuation of the property sold. If the property is undervalued, the IRS can assert that the transfer was in part a gift.

b. Valuation of the note. If the note itself, or the overall transaction, is not properly structured and lacks arm's length characteristics, the IRS can take the position that the note is not adequate consideration, resulting in a gift and possibly even Section 2036 issues.

c. The income tax treatment of the sale at the death of the grantor is uncertain.

d. The assets transferred in the sale may perform poorly or the note is difficult to repay for other reasons.

4. Valuation of the property sold. In a sale transaction, the asset being sold usually will not be publicly-traded and therefore will be subject to valuation uncertainties.

   a. The first step in avoiding a gift due to IRS revaluation of the property is to obtain a well-written appraisal of the asset and any applicable valuation discounts.

   b. The appraisal also will help satisfy the requirements for adequate disclosure of the transfer and start the statute of limitations running if the sale is disclosed on a gift tax return. See Treas. Reg. § 301.6501(o)-1(f).

   c. It generally is advisable to disclose sales on a gift tax return in order to obtain the benefit of the gift tax statute of limitations.

   d. The IRS has made changes to the Form 706 that encourage this strategy, even though the taxpayer is not required to report the transaction. Part 4–General Information of the Form 706 includes the following question:

      "12e Did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?" [covering any trusts created by the decedent during his or her lifetime and any trusts not created by the decedent under which the decedent possessed any power, beneficial interest or trusteeship]

5. The next logical step in minimizing valuation risk is to build into the transaction some form of adjustment clause that resets the transaction terms in response to changes in the value of the asset. The ability to use an adjustment provision has been a rapidly evolving area of the law in the past twelve years. The latest Tax Court case, Wandry v. Comm'r, TC Memo 2012-88, upheld the use of a defined value clause.

   a. In Wandry, the taxpayer used a simple formula transfer clause:

      "I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC … so that the fair market value of such units for federal gift tax purposes shall be as follows: … Kenneth D. Wandry … $261,000 …"

      A list of donees and gift amounts followed.

   b. For example, a gift of $15,000 worth of LP units in XYZ Family Partnership is a Wandry clause. It refers to the amount being given, not the number of units. In describing how the clause works, many practitioners have used the analogy of going to the gas station and asking to buy $20 worth of gas.

c. The court rejected the application of the public policy reasoning of Procter and concluded that the parents made gifts of specific dollar values of units. The court made a distinction between a formula clause that might result in a later adjustment and a savings clause that sought to unwind or adjust gifts that were of a fixed number of shares or units.

d. It also did not find the presence of a charitable donee to be a necessary prerequisite to supporting a formula clause.

6. The assignment forms in Wandry provided that each donor intended to have a good faith determination of the value made by an independent third party professional. The number of units transferred would be based on that appraisal. If the IRS challenged the valuation and a final determination of a different value was made by the IRS or a court, the number of gifted units was to be adjusted accordingly so that the value of units given to each person equaled the dollar amount specified in the assignment. The assignments specifically stated that the formula was to work in "the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

a. The gift tax return described the gifts to the children and grandchildren in terms of percentages of membership interest in the LLC. These percentages were derived from the value determined by an independent appraiser. The IRS claimed that the gifts of 2.39% interests to each child and a .101% interest to each grandchild saying that the membership interest should have been valued at a higher amount. The IRS and the taxpayers agreed that the 2.39% and the .101% LLC membership interests were worth $315,000 and $13,346. The IRS argued that the formula did not work to reduce the amount transferred, as the taxpayers claimed.

b. The court noted that in Estate of Petter, it had examined the difference between savings clauses, which had been rejected by Comm'r v Proctor and which a taxpayer may not use to avoid the gift tax, and a formula clause, which is valid. A savings clause is void because it creates a donor that tries to take the property back. A formula clause is valid because it merely transfers a "fixed set of rights with uncertain value." The difference, according to court, depends on an understanding of exactly what the donor is trying to give away.

c. In this case, the donees were entitled to receive predefined interests which were essentially expressed as a mathematical formula in which the one unknown was the value of an LLC unit at the time the transfer documents were executed. However, though the value per unit was unknown, the gift value was a constant. The court noted that absent the audit, the donees might never have received the proper LLC percentage interests to which they were entitled. That did not mean that parts of petitioners' transfers depended upon an audit. Instead an audit merely ensured that the children and grandchildren would receive the interest that they were always entitled to receive.

d. The court said that it was "inconsequential" that the adjustment clause reallocates membership units among petitioners and the donee rather than a charitable organization as in prior cases such as Christensen and Petter. In the court's view the gift documents did not allow petitioners to take property back. Rather the gift documents corrected the allocation of the membership units among donors and donees because the independent appraiser's report understated the value. As a result, the assignments contained valid formula clauses.

e. The court also rejected the public policy concerns expressed in Proctor. It stated that there is no well-established public policy against formula clauses. The role of the IRS is to enforce the tax laws, not to maximize tax receipts.

7. The Wandry case is a major development in establishing the validity of defined value clauses. But it is only a Tax Court Memorandum opinion, so its precedential value is limited.

a. The IRS initially filed a Notice of Appeal in the case but then dropped the appeal. The appeal would have gone to the Tenth Circuit, which is where one of the few pro-taxpayer savings clause cases was decided, under King v United States.

b. The Service published a non-acquiescence to Wandry in IRB 2012-46. Thus, it appears that the IRS is waiting for a more favorable opportunity to challenge the case.

c. In certain respects, it does seem that Wandry is contrary to the Proctor line of cases. The IRS certainly will argue that a defined value clause results in the donor taking property back and that this is a condition subsequent of the type prohibited in Proctor.

d. However, the IRS must overcome the many circumstances in which it has either directly sanctioned, or declined to challenge, formula clauses. Formula disclaimers, formula marital deduction provisions, formula GST exemption allocations, formula annuity provisions in GRATs and charitable split-interest trusts are common.

8. If a taxpayer uses a Wandry-type clause, the gift tax return should describe the gift as a dollar amount not a specific number of shares or units, or percentage interest. The taxpayer in Wandry did not do this, and this oversight gave the IRS its most powerful argument.

   a. In order to satisfy the adequate disclosure rules, it still probably is necessary to identify the number of shares or units that the taxpayer is claiming to have transferred.

   b. This can be done by describing the gift first as a dollar amount but with an additional explanation: "The taxpayer transferred $2,500,000 of her interest in Dough Family Limited Partnership. Based on the appraisal by Honest Lee Valuation Group, the amount transferred equated to a 2.5% interest in the Partnership. However, the amount the taxpayer transferred a fixed dollar amount of limited partner interest, and the percentage interest will be adjusted if there is a final determination of a different value, so that the value of the interest transferred equals $2,500,000."

9. Valuation and attributes of the promissory note. If the note is not given arm's length attributes, or the trust that is purchaser of the asset does not have sufficient independent assets, the IRS could argue the note has a value that is less than face value. This would result in a gift.

   a. As noted earlier, the IRS would need to overcome regulatory presumptions about the face value of the note, but that is not insurmountable if the taxpayers structure the transaction in a manner that would never be done in arm's length transactions.

   b. In the alternative, the IRS could claim the note is not really debt, and if the grantor dies while the note is outstanding, it could treat the transfer as a gift with retained interest in the trust, resulting in application of Internal Revenue Code Section 2036.

   c. Many tax professionals recommend that the trust should be separately funded with assets having a value equal to at least 10% of the purchase price in the installment sale, in order to minimize the likelihood of the IRS claiming a gift occurs. See Letter Ruling 9535026, where the IRS suggested that a minimum of 10% equity in the trust would give validity to the transaction.

   d. This creates a possible limit on the size of the transaction. If a client wants to sell a $30 million interest in a company to a grantor trust, he arguably should first fund the trust with a gift of $3 million. The client may not have that much exclusion remaining.

e. Some practitioners use guarantees to support the legitimacy of the transaction and the value of the note. For example, a child with financial resources who is a beneficiary of the trust that acquires the asset could guarantee payment of the note to the trust.

(1) In some cases, a guarantee is used instead of seed money.

(2) More frequently, it is used to support the seed gift, or where the grantor does not have enough gift exclusion remaining to provide an adequate seed gift.

f. There is virtually no guidance on whether the IRS will treat guarantees as effective, and on the tax consequences, if any, when the parties create a guarantee.

(1) Many practitioners who use guarantees advise that the trust should pay the guarantor a fee for providing the guarantee. This is in response to Letter Ruling 9113009, where the IRS ruled that the agreement to provide a guarantee constituted a gift to the benefited party if there was no consideration. The IRS later withdrew this ruling (see Letter Ruling 9409018) but it nevertheless reflects possible IRS thinking on the subject.

(2) In addition, practitioners may recommend that the trust use an independent trustee to negotiate the guarantee and fee, and/or that the fee to be paid be determined by an independent appraiser. It only makes sense to consider these alternatives in a very large transaction, given the additional costs they entail.

g. Some transactions do rely entirely on a guarantee to support the debt issued. One technique used by some attorneys is the "beneficiary defective trust," also referred to as the "beneficiary irrevocable grantor trust" and discussed later in this outline. It is an irrevocable trust funded with annual exclusion gifts subject to Crummey rights of withdrawal. The Crummey rights make the beneficiary the beneficiary the grantor of the trust for income tax purposes pursuant to Internal Revenue Code Section 678. After the trust is seeded with some annual exclusion gifts, the beneficiary then sells an asset to the trust. In this scenario, the initial gift is far less than 10% of the value of the asset sold. The transaction uses the guarantee for economic substance.

h. There are no cases or rulings that examine the use of a guarantee in the context of a sale to an IDGT. There will be situations in which the use of a guarantee is the best, or maybe only option, for providing economic substance to a transaction. It can increase the cost and complexity, and given the uncertainty of the Service's position, it clearly adds risk.

10. Income tax consequences of death of grantor. If the grantor dies while the note is outstanding, the IRS could treat the conversion of the trust to a non-grantor trust as a taxable event.

a. There is authority supporting the conclusion that the grantor's death is a taxable event for income tax purposes. In effect, there is a new exchange upon termination of grantor trust status, in which the property is transferred to a non-grantor trust equal to the value of the principal amount of the note outstanding. This conclusion is based on the authority that treats a termination of grantor trust status during the grantor's life as a taxable event. See Treas. Reg. § 1.1001-2(c), Example 5; Madorin v. Comm'r, 84 TC 667 (1985); Rev. Rul. 77-402, 1977-2 CB 222.

b. Some commentators have asserted that the death of the grantor should not be treated as a taxable event. They have noted that the existing legal authority addresses only events during the life of a taxpayer that result in the end to grantor trust status in the case of a trust, or to disregarded entity status in the case of entities other than trusts.

(1) For example, Treas. Reg. § 1.1001-2(e), example 5, involves a taxpayer who transfers an asset subject to a liability to a grantor trust and who subsequently renounces the power that causes grantor trust status. The example concludes that a sale is deemed to occur when the power is renounced.

(2) The commentators make the case that a testamentary transfer is different, and is subject to the overriding rule in the Code that testamentary transfers are not subject to capital gain. For an extensive discussion of this issue, see Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reasons of the Grantor's Death", 97 J Tax'n 149 (Sept. 2002) (hereafter "Income Tax Effects of Termination").

(3) The authors go further in "Income Tax Effects of Termination", and assert that the death of the grantor, and deemed change of ownership for income tax purposes that results, gives rise to a step-up in basis for the grantor trust's assets. Their argument is that the change in income tax ownership is, for income tax purposes, the receipt of

property from a decedent under Internal Revenue Section 1014.

(4) The IRS has not yet confronted these questions. Its 2015-2016 Priority Guidance Plan for the first time identified a project to promulgate guidance on the basis of grantor trust assets at death under Internal Revenue Code Section 1014.

(5) Until taxpayers receive some guidance, they are left with the possibility that the death of the grantor while the note is outstanding could trigger capital gain.

(6) It is clear that regardless of the treatment of the transaction from capital gain purposes, interest payments made after the death of the grantor will be taxable to the recipient.

c. The risk of a taxable event at the death of the grantor can be avoided if the note is fully paid during the grantor's life. An extremely long-term note or a note with a balloon principal payment is less likely to be paid in full while the grantor is alive. This of course means that the risk of confronting one of these tax issues is greater.

d. It also may be advisable to have a plan to pay off the installment note if the grantor's death appears imminent. For example, the grantor and the trust could take whatever preliminary steps are necessary to line up temporary financing from a bank or other commercial lender. If the grantor is near death, the trust could borrow from the bank and pay off the installment note. After the grantor's death, the grantor's estate could lend the money back to the trust in order to re-institute the private financing, and the trust would pay off the loan from the bank.

11. Note repayment issues. The final major issue inherent in a sale to an IDGT is how the trust will repay the note. Ideally, either the property already in the trust or the property sold to the trust should produce a cash flow in some manner in order to make payments on the note.

a. It is preferable if interest can be paid annually on the note. The payment of interest is not necessary to avoid the income tax provisions in the imputed interest rules of Internal Revenue Code Section 7872, since the interest is not being paid to a separate taxpayer. The failure to provide for interest would discount the value of the note substantially, however. If the interest required by the note is not paid, and the prospects for payment based on the nature of the asset are poor, the IRS could claim the parties knew that interest would not be paid when they entered into the transaction, and try to discount the note on that basis.

b. If the asset sold is illiquid and not income producing, it is possible for the trust to make the installment payments, including the interest, by distributing assets in-kind to the grantor. Because the trust is a grantor trust, payment in-kind can be done without income tax consequences to either the trust or the grantor. However, if this is done on a consistent basis, it could increase the risk that the IRS would try to apply Internal Revenue Code Section 2036 to the transaction, or otherwise try to collapse it. The IRS would argue that the grantor never really completely transferred ownership of the property if it was clear from the beginning that the trust would have to use the property itself to make interest payments.

c. Ultimately, the principal balance of the note also must be paid or discharged in some manner. This is often done by having the trust purchase an insurance policy on the grantor's life.

d. The grantor must also assess the risk that the asset transferred may decrease in value. If the grantor made a large gift to the trust, both those assets and the assets sold to the trust could be used to repay the note. The grantor does not get back the exclusion used for the gift if this occurs.

Q. Self-Canceling Installment Notes (SCINs). A SCIN—a note having a fixed term but which terminates by its terms at the seller's death—is a hybrid using the installment approach to determine the maximum payments to be made by the buyer and using the private annuity approach (discussed later in these materials) on cessation of payments if the seller dies before all payments have been made.

1. The seller in a SCIN transaction can enjoy the same potential estate and gift tax savings as the transferor in a private annuity. The SCIN can be used to shift excess appreciation to the heirs of the seller. If the seller dies before the end of the term of the note, the SCIN can produce significant estate tax savings.

> **EXAMPLE:** Mother, age 60, sells property worth $2 million to her daughter for a 10-year SCIN. Daughter agrees to pay mother $300,000 a year for 10 years, which reflects the $2 million value with an interest rate premium for the self-canceling feature. Mother dies after receiving only two payments. As a result, mother has received $600,000 in note payments and removed $2 million of property, plus appreciation, from her estate. If mother is in the 40% marginal estate tax bracket, then the transaction has reduced the estate by $560,000 ($2 million minus $600,000 in installment payments x 40% federal estate tax rate), not taking account of appreciation.

2. Another possible advantage to a SCIN is as a retirement planning device. The SCIN can allow younger generation family members to supplement a parent's retirement income without gift tax. Because of the premium required on a SCIN, the payments in a SCIN would generally exceed payments under conventional installment sales or private annuities. This can provide a larger amount of income for older family members in their retirement years.

3. To avoid a gift, the self-canceling feature should provide a premium to the seller. See Moss v. Comm'r, 74 TC 1239 (1980).

   a. The premium may be reflected either in the interest rate or in the purchase price and other terms.

   b. Using separate counsel or valuation professionals helps substantiate the premium as a bargained-for element of the transaction.

   c. Several valuation programs provide recommendations on the amount of the premium, based on the term of the note and life expectancy of a person the same age as the seller.

      EXAMPLE: Carlos sells a $5,000,000 asset to an irrevocable trust he created for a 15-year self-cancelling installment note, with amortized payments. Carlos is age 70 at the time of the transfer. Using the NumberCruncher program produced by Leimberg & LeClair, Inc., if the parties choose to reflect the premium in the interest rate, the note should pay interest at a rate of 4.837% rather than 2.64%. If the parties choose to reflect the premium in the purchase price, the principal amount of the note should be $5,838,519 rather than $5,000,000.

4. The IRS challenged the valuation of a SCIN in the recently settled docketed Tax Court case, Estate of Davidson v. Comm'r. The SCIN in that case was an interest-only note with a balloon payment. The IRS asserted that taxpayers could not rely on the actuarial factors embodied in the Section 7520 tables to determine premiums; that the tables apply only to the valuation of life estates, annuities, and remainder interests, not to promissory notes. The application of a pure willing buyer-willing seller analysis for SCINs would significantly complicate their use.

5. The income tax treatment of SCINs is discussed in General Counsel Memorandum 39503 (June 28, 1985) and Frane v. Comm'r, 98 TC 341 (1992) rev'd in part 998 F2d 567 (8th Cir 1993). SCINs offer a number of advantages that may make them preferable to private annuities under appropriate circumstances.

a. If the transferred property is used in a trade or business or held for investment, a SCIN generates deductible interest for the buyer. For buyers in high income tax brackets, the SCIN's risk premium may generate larger interest deductions if the premium is paid in the form of higher interest. Alternatively, the premium can increase the buyer's basis and depreciation deductions if it is paid in the form of a higher purchase price.

b. Whereas a SCIN limits the number of payments to the seller, payments under a life annuity may continue long enough to defeat the estate reduction purpose of the original transfer.

6. If the holder of the SCIN dies before receiving all of the note payments, nothing is includible in the gross estate, but the Internal Revenue Code Section 453B installment obligation disposition rules apply and accelerate the balance of the gain by treating the cancellation as a transfer. The transfer is deemed to be made by the decedent's estate, and is taxable to the estate under Internal Revenue Code Section 691(a)(2), with the income being includible on the decedent's estate's first fiduciary income tax return (Rev Rul 86-72, 1986-1 CB 253, and Frane). It is not clear how this treatment would apply in the case of a sale to a grantor trust.

7. For a SCIN transaction to be effective, the sale must be a bona fide transaction. In Costanza v. Comm'r, TC Memo 2001-128 (June 4, 2001), the Tax Court found that SCIN failed since the sale was from a father to a son, the son failed to make interest payments in a timely fashion (and only three payments were made before the father's death), and given the father's history of illness, there was a high probability that father would not survive the eleven year term of the note. The Tax Court's decision was subsequently reversed (320 F3d 595 (6th Cir 2003) but even on appeal, the court noted that the starting point in analyzing such inter-family transactions should be that there is not truly arm's length dealings between the parties.

R. Comparison of GRAT and IDGT

1. The GRAT and the sale to an IDGT are often alternatives to be considered for the same asset. Both are especially effective if the asset involved is stock in an S corporation or interests in another type of flow through entity, like a partnership or LLC.

2. Advantages of a sale to an IDGT.

a. A sale to an IDGT generally allows the client to use a lower discount rate.

(1) The interest rate required for the promissory note in a sale may be lower than the rate used for determining the value of an annuity interest in a GRAT. If the promissory note uses

the applicable federal rate (AFR), the rate should be adequate to avoid gift tax consequences. In a GRAT, the value of the annuity is calculated pursuant to Section 7520 using 120% of the mid-term AFR. A lower rate for the promissory note results in less property being paid back to the grantor.

(2) For many years, the long-term AFR was below the Section 7520 rate. For example, in May, 2007, the Section 7520 rate was 5.6%. The long-term AFR was 4.90%.

(3) More recently, this has not been the case. The February 2016 Section 7520 rate of 2.2% is less than the long-term AFR of 2.62%. It is greater than the mid-term AFR of 1.82%.

b. A sale to an IDGT does not involve a direct mortality risk.

(1) If the client engages in a sale and dies before the end of the term of the promissory note, only the value of the unpaid balance of the note will be included in his estate. If he dies during the GRAT term, the entire value of the transferred property is included in his estate.

(2) However, as explained in the previous Section, there are other possible tax consequences to dying during the term of an installment note.

(a) If the installment sale is not properly structured as an arm’s length transaction, and the grantor dies while the note is outstanding, the IRS could treat the note as a retained interest in the trust, and include part or all of the trust in the grantor’s estate under Internal Revenue Code Section 2036.

(b) Upon the grantor’s death, the trust will lose its grantor trust status.

c. An individual can engage in generation-skipping tax planning with a sale to a grantor trust by allocating GST exemption to the trust.

(1) If an individual gifts $10,000,000 to a grantor trust, and then sells $100,000,000 worth of stock in exchange for a note from the trust, she would need to allocate $10,000,000 of GST exemption to the trust, an amount sufficient to cover the initial gift.

(2) The GRAT is subject to the ETIP rules. A taxpayer cannot allocate GST exemption to the GRAT until the end of the

annuity term, at which time the then-current value of the trust is used for the allocation.

d. There is more flexibility in structuring the payments to the grantor in an installment sale. For example, a balloon principal payment can be used, the interest rate can be tied to the prime rate, or the term of the note and interest can be renegotiated after the sale is completed. A GRAT must pay the annuity every year and the annuity may change only as provided in the regulations. See Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

e. The installment sale can provide for prepayments of principal. That alternative is not available in a GRAT.

3. Advantages of a GRAT.

a. It often will be possible to have a smaller gift with a GRAT than with a sale to an IDGT of comparable size. The conventional wisdom is that an installment sale transaction will run less of a risk of being challenged for lack of substance if the trust that is the purchaser has assets equal to at least 10% of assets being sold to it. If there is not a pre-existing grantor trust, this can mean that a considerable gift is necessary to fund the trust.

(1) For example, assume an individual wishes to sell $25 million of stock to a grantor trust for a 20-year note. The individual would need to fund the trust with an initial gift of $2.5 million. Even if both the individual and his or her spouse had their full lifetime exclusions of $2,000,000 remaining, there would be gift tax due on the gift.

(2) For a GRAT, the gift is tied to the size of the annuity and the length of the annuity term. Thus, if an individual wishes to transfer a significant asset that is expected to have a very high rate of appreciation, the gift may be more affordable if a GRAT is used.

(3) For example, assume the same individual transfers $27.5 million to a Walton GRAT paying 8.5% per year for a term of 20 years. If the individual is age 50 and the Section 7520 rate is 6.0%, the gift upon creating the GRAT is $689,110. This is just less than thirty percent of the size of the gift to fund an IDGT for a sale with the same total amount of stock.

b. A GRAT also provides more protection if the IRS challenges the value of the asset being transferred.

(1) With an IDGT, if the individual sells a $5,000,000 asset for a $5,000,000 note, and the value of the asset is increased on audit to $6,000,000, then, absent a value adjustment clause or Wandry type provision, the individual would be treated as making a $1,000,000 gift.

(2) In a GRAT, the annuity is usually expressed as a percentage of the initial fair market value of the assets contributed to the trust. If the IRS increases the value of the assets transferred to a GRAT on audit, the annuity also increases. The gift does not increase dollar-for-dollar with the increase in the value of the assets. As illustrated in the second example, if the GRAT is effectively a zeroed-out GRAT, the impact of adjusting the value of the property initially transferred to the trust is virtually nil.

> **EXAMPLE:** Jane, age 55, transfers a $5,000,000 asset to a GRAT and retains the right to receive a 12.5% annuity for 10 years. Jane is treated as making a gift of $311,500. On audit, the IRS proposes to increase the value of the asset to $6,000,000. The annuity that the GRAT must pay each year would increase from $625,000 to $750,000. The gift would increase to only $373,800.

> **EXAMPLE:** Jane transfers a $5,000,000 asset to a GRAT and retains the right to receive a 23.4818% annuity for 5 years. Jane is treated as making a gift of $20.33. If the IRS proposes to increase the value of the asset to $6,000,000, the gift would increase to $24.39.

c. The size of the gift also is relevant in considering the possibility that the asset transferred could drop in value, or grow only modestly. If this occurs, it is possible that all the assets in the GRAT or IDGT will be paid back to the grantor to satisfy the annuity or note payments. If the grantor has made a larger taxable gift to fund the IDGT, those assets all could end up being paid back to the grantor, with no restoration of applicable exclusion amount used to make the initial gift, or no credit for any gift tax paid.

d. Finally, because the GRAT is a statutorily sanctioned technique, there is more certainty about how it will be treated by the IRS. Assuming the value of the asset transferred to the GRAT is not questioned, the grantor knows how the transaction will be treated for transfer tax purposes. The determination of the values of the annuity interest and the gift are mechanical calculations using the IRS valuation tables.

(1) There are more uncertainties with a sale to an IDGT. As previously explained, if the grantor trust is not adequately funded or if the sale is not otherwise structured as an arm's length transaction, the IRS could challenge the substance of the transaction and treat it as something other than a sale.

(2) The one aspect of an IDGT that does not have to be strictly arm's length is the interest rate. As previously described, if the note bears interest at a rate equal at least to the AFR applicable for the term of the note, the interest should be adequate, even if the AFR is below the commercial interest rate for such a transaction. The IRS seems to have conceded that an interest rate at least equal to the AFR is sufficient.

S. Special Planning with Grantor Trust Status

1. Supercharged Credit Shelter Trust[5]

a. The goal behind a supercharged credit shelter trust is to increase the effectiveness of a credit shelter trust for transfer tax purposes by making it a grantor trust as to the surviving spouse.

b. This allows the trust to continue to have the same benefits that a grantor trust does during the life of the grantor.

c. The supercharged credit shelter trust starts as a lifetime QTIP trust created by one spouse in a couple for the other spouse.

(1) During the life of the beneficiary spouse, the trust operates as a marital trust, paying all the income to that spouse.

(2) The trust is treated as a grantor trust for income tax purposes because the spouse is a beneficiary. IRC § 677.

d. On the death of the beneficiary, the trust is included in that spouse's estate and the trust property (or that portion equal to the deceased spouse's remaining applicable exclusion amount) can pass to a credit shelter trust for the grantor spouse. The trust continues as a

[5] The "Supercharged Credit Shelter Trust" is a service mark of Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S. C. Zeydel. They first advanced the concept in various articles and presentations.

grantor trust for that grantor spouse. See Treas. Reg. § 1.671-2(e)(5).

e. The goal of course is to have the spouse most likely to survive create the lifetime QTIP trust. Each spouse could create a lifetime trust for the other, and vary the terms sufficiently to avoid possible application of the reciprocal trust principles. In that case, only one trust ultimately will be supercharged.

2. Beneficiary Irrevocable Grantor Trust ("BING")

a. The Beneficiary Irrevocable Grantor Trust is designed to take advantage of the provisions of Section 678 of the Internal Revenue Code which make the beneficiary of a trust the grantor for income tax purposes under certain circumstances.

b. Internal Revenue Code Section 678(a) provides that a person other than the grantor will be treated as the owner of any portion of a trust with respect to which that person has a power of withdrawal or previously had such a power and partially released or modified it, assuming the person continues to have interests in the trust that would cause an actual grantor to be treated as the grantor under Internal Revenue Code Sections 671 through 677.

c. The IRS has repeatedly applied Internal Revenue Code Section 678 to the Crummey trusts, and maintained the position that the beneficiary becomes the grantor of the trust for income tax purposes to the extent of the portion of the trust attributable to lapsed Crummey powers.

d. A wealthy taxpayer can take advantage of these rules by having a parent or other family member create a Crummey trust for the taxpayer. The trust can be funded over a few years with $5,000 gifts, subject to a Crummey power in the wealthy beneficiary. The Crummey power lapses, and the beneficiary treats the trust as taxable to him or her.

> **EXAMPLE:** John is an entrepreneur with a significant estate. John's mother creates a trust for John and his descendants in November and funds it with $5,000 gifts in November and January of the following year. The gifts are subject to a Crummey right of withdrawal in John. The trust is treated as subject to Internal Revenue Code Section 678, and the income is reportable by John on his Form 1040.

e. John now can sell property to the trust in an installment sale, with the tax attributes being identical to any sale to a IDGT. However, John also maintains a beneficial interest in trust. Furthermore, the trust continues as a grantor trust as to him for his life, long after his mother is deceased.

> **EXAMPLE:** In June of year two of the trust, John sells $5,000,000 of stock in a venture capital entity to the trust in exchange for a $5,000,000 note. The sale is treated as a sale to a grantor trust. The entity liquidates 5 years later and pays out $10,000,000 to the trust. The trust repays the note.

f. The transaction is possibly subject to IRS attack because the trust is under-capitalized at the time of the sale. Guarantees would need to be provided to address this risk.

g. In addition, there is much greater risk to the transaction if the IRS is successful in arguing that the property transferred has a greater value. If John is treated as making a gift to the trust, Internal Revenue Code Section 2036 will apply because he also is a beneficiary.

3. Delaware Irrevocable Non-grantor Trust ("DING")

a. The IRS has been asked to rule repeatedly on the income and gift tax consequences of a trust intended to be an incomplete gift, non-grantor trust. A trust of this nature is commonly referred to as a Delaware incomplete gift non-grantor trust or "DING," if created under Delaware law, or a Nevada incomplete gift non-grantor trust or "NING," if created under Nevada law.)

b. As its name implies, a DING or a NING is structured to be a non-grantor trust for income tax purposes that is funded by transfers from the grantor that are incomplete gifts for gift tax purposes. Assuming the trust is established in a state that doesn't tax the income accumulated in the trust (like Delaware or Nevada), the trust will avoid state income taxes as long as the state of residence of the grantor or beneficiaries doesn't subject the trust's income (or accumulated income) to tax. Moreover, if structured and administered properly, the trust property should be protected from the grantor's creditors.

c. The DING or the NING allows a grantor to achieve both of these benefits while still being able to receive discretionary distributions of trust property and without paying gift tax (or using any gift tax exemption) on the transfer of property to the trust. A gift from the grantor will be complete upon a subsequent distribution from the trust to a beneficiary other than the grantor, and whatever property remains in the trust will be subject to estate tax at the grantor's death.

d. A DING or NING is particularly attractive for a highly appreciated asset in anticipation of sale of that asset. For example, the founder of a business that is going to be sold may face hundreds of thousands or even hundreds of millions of dollars of capital gain because he or she has so little basis. Avoiding state income tax on those gains can be a significant benefit.

e. The IRS does not appear to be closely scrutinizing these trusts. They are issuing frequent rulings approving them. See, e.g. Letter Rulings 201440008 through 201440012 (Oct. 3, 2014); Letter Rulings 201436008 through 201436032 (Sept. 5, 2014); Letter Rulings 201430003 through 201430007 (July 26, 2014); Letter Rulings 201410001 through 201410010 (March 7, 2014).

(1) The Service may view these trusts as beneficial to the bottom line. A non-grantor trust may pay slightly more tax than an individual taxpayer.

(2) States are that the ones that lose tax dollars from these trusts. New York passed legislation, effective for income earned on or after January 1, 2014 (unless the trust was liquidated before June 1, 2014) to treat such trusts as grantor trusts for New York income tax purposes.

f. The key in creating an effective DING or NING is to structure distribution provisions that leave the grantor with enough control so that the initial transfer to the trust is not a completed gift, but there is sufficient involvement of parties adverse to the grantor to avoid the grantor trust rules. For example, the trust would permit distributions to the grantor or the other designated beneficiaries as follows:

(1) The trustee must distribute to the grantor or a beneficiary at the direction of a majority of a distribution committee, with the grantor's written consent;

(2) The trustee must distribute to the grantor or a beneficiary at the unanimous direction of the distribution committee;

(3) The grantor, in a non-fiduciary capacity, may distribute to any beneficiary for health, maintenance, support or education.

(4) The initial distribution committee was the grantor, her children and her stepchildren. The committee always must have at least two members other than the grantor.

T. Low-Interest or Interest-Free Loans

1. A simple way for a client to take advantage of the current low interest rate environment is to lend funds at the AFR to a child, grandchild or trust for the benefit of one or more descendants, to enable the recipient to take advantage of investment opportunities with a potential for high returns.

> **EXAMPLE:** Clara creates an irrevocable grantor trust in June, 2006 for the benefit of her descendants. Clara makes a $1,000,000 taxable gift to the trust in 2015, which she splits with her spouse, and which uses a portion of their applicable exclusion amounts. They allocate GST exemption to completely exempt the trust. Thus, after the gift, they have a $1,000,000 trust that is completely exempt from gift, estate and GST taxes. In January 2018, Clara lends an additional $2,000,000 to the trust for a 5-year note bearing interest at 1.67% annually (the mid-term AFR). The principal is due in a balloon payment at the end of the term.

2. Several benefits may result from this arrangement.

a. The trust has obtained $2,000,000 of investment capital at a rate less than what is available commercially.

b. The annual interest cost for the loan is $33,400 (1.67% of $2,000,000), or $167,000 in total over three years.

c. If the trust invests the $2,000,000 and earns a return of 7% annually over 5 years, it will earn over $105,000 per year on the spread. (This is in addition to earnings on the original $1,000,000 corpus received by gift.)

d. After the repayment of principal after 5 years, the trust will have $613,025 remaining from the loaned funds, plus the $1,000,000 originally given to the trust plus investment earnings on that $1,000,000.

3. If the trust is structured as a grantor trust, the grantor will be responsible for all income taxes on income generated by the trust. In addition, the annual interest payments on the loan will not be taxable income to the grantor. In the foregoing example, the annual $33,400 of interest payments to Clara will not be taxable income to Clara.

4. There is no additional gift or generation-skipping transfer to the trust as a result of the loan.

5. In the proper circumstances, the client may want to consider an interest-free loan instead of a low-interest loan.

   a. If the loan is made to a grantor trust, the grantor should not have to recognize imputed interest income, because the loan is not being made to a separate taxpayer.

   b. There will be an imputed transfer that is treated as a gift. In a term loan that charges no interest, the amount of the gift will equal the difference between the amount lent and the present value of all principal payments due under the loan, discounted using the relevant AFR on the date of the loan. The gift is deemed to occur on the date of the loan.

      > **EXAMPLE:** Chris makes an interest-free loan of $295,000 to an irrevocable grantor trust that he previously created and funded with $300,000. The term of the loan is 10 years, with the principal due in a single balloon payment at the end of the term. If the AFR at the time of the loan is 5.3%, the present value of the loan is about $175,000, and Chris is treated as making a gift of $120,000 ($295,000-$175,000).

   c. If the trust contains Crummey powers, it may be possible to grant the beneficiaries withdrawal rights at the time the loan is made and thereby qualify the imputed gift for the annual exclusion. Recognize that this particular treatment has not been reviewed or ruled upon by the IRS. However, if the Crummey powers are otherwise properly structured and documented, and there are trust assets available to satisfy the withdrawal rights if they were exercised, the present interests created in the trust beneficiaries should be treated as having substance.

   d. In this context, the interest-free loan becomes an alternative to a direct annual exclusion gift to the trust.

      > **EXAMPLE:** Chris makes a $295,000 interest-free loan to an irrevocable grantor trust under the same facts as the previous example. The trust grants each of Chris's descendants a Crummey power of withdrawal. At the time of the loan, notice of withdrawal rights are given to Chris's three children and three grandchildren, and the $120,000 imputed

> gift is treated as six annual exclusion gifts. The trust invests the $295,000 in investments that return 8%. After 10 years, the trust has $636,883 as a result of investing the borrowed funds. After repaying the $295,000 loan, the trust has $341,883 from the loan.

If Chris had made a $120,000 direct gift to the trust, and the trust invested the funds for 10 years at 8%, it would have $259,071 after 10 years. The interest-free loan provides $82,812 more for the trust.

e. An individual also could make an interest-free demand loan to a grantor trust. With a demand loan, the imputed interest each year is treated as a gift in that year.

> **EXAMPLE:** Chris makes a $7,000,000 interest-free loan to an irrevocable grantor trust. The AFR at the time is 1.67%. Chris is treated as making a gift of the imputed interest on the loan for the year, which is $116,900. The trust grants Crummey powers to Chris' six descendants, and he treats the gift as qualifying for the annual exclusion.

f. The danger with demand loans is that the lender cannot lock in an interest rate. If the AFR goes up, there will be more imputed interest and a larger gift.

U. FLPs and LLCs

1. Over the past 25 years, many individuals have been using a family-owned limited partnership ("FLP") or limited liability company ("LLC") as a vehicle for managing and controlling family assets.

a. A typical family partnership is a limited partnership with one or more general partners and limited partners.

b. Usually, the parents act as general partners of the partnership or own a controlling interest in a corporate general partner. As general partners, the parents manage the partnership and make all investment and business decisions relating to the partnership assets. The general partnership interest usually is given nominal value, with the bulk of the partnership equity being limited partnership interests.

c. Initially, the parents receive both general partnership interests and limited partnership interests. Thereafter, the parents can transfer their limited partnership interests to the children.

> **EXAMPLE:** Parent transfers $10,000 of his $1,000,000 of real estate, cash and securities to his

children. Parent contributes the remaining $990,000 of investments to a newly formed partnership, to which the children contribute their $10,000. Parent receives a general partnership (GP) interest worth $10,000 and limited partnership (LP) interests with a net asset value of $980,000. The children receive $10,000 of LP interests. Parent make gifts of the $980,000 of LP interests to children.

2. An LLC can be structured in much the same way as a limited partnership. The parents or one of them, often act as Manager and thereby control the decision-making. Initially, the parents receive the bulk of the LLC member interests. Over time, they can transfer most or all of those interests to their children. The LLC can provide an attractive alternative to the use of a partnership, especially where there is a desire to limit the personal liability of all the participants in the entity without having to create a separate entity for the general partner.

3. Non-Tax Estate Planning Benefits

   a. The FLP or LLC addresses the problems faced by many individuals who may be in a financial position that would permit them to gift property to children, but who are reluctant to do so because they are unwilling to give up management and control of the property, or do not want children to own the property directly.

   b. The FLP or LLC interests represent a right to a share in the entity income and capital, but grant no voice in management of the entity. This structure permits an individual to make gifts of FLP or LLC interests to his spouse, children, and (eventually) more remote descendants, without transferring the underlying assets. As general partner of the partnership or manager of the LLC, the individual can continue to exercise control over the transferred interests. Thus, the individual can transfer interests in the entity to reduce the value of his estate, and retain authority to manage the property. This combination is difficult to achieve in most circumstances. Normally, if a person gives away property, he can no longer exercise control over it.

   c. The partnership or LLC agreement also can restrict the ability of any recipient of interests to make further transfers of those interests, by limiting the persons to whom any transfer could be made during life or at death, and the amount that the entity would be willing to pay a partner upon liquidation of his or her interest. These restrictions will help ensure that the interests are kept in the family and will help protect the underlying assets from potential creditors of a child, or from a spouse of a child in a failed marriage.

d. Many of the benefits that a FLP or LLC provides also can be achieved by making gifts to an irrevocable trust for children or more remote descendants. In a number of respects, though, a FLP or LLC provides flexibility not available in a trust.

(1) Unlike an irrevocable trust, the terms of the FLP or LLC can be amended to address changing circumstances.

(2) A FLP or LLC gives the managing partner or the manager greater latitude with respect to management decisions than a trustee of a trust may have. A managing partner's or manager's actions will be judged under the "business judgment rule" rather than the more restrictive "prudent man rule" applicable to a trustee.

(3) Although an individual who creates an irrevocable trust often can retain management control over trust assets by naming himself as investment adviser, the individual generally cannot retain the trustee's discretionary authority to make distributions without causing Internal Revenue Code Sections 2036 or 2038 to apply.

(4) The long-standing law with respect to business entities has been that the individual can retain this control as general partner of a FLP or manager of the LLC without Internal Revenue Code Section 2036 or 2038 applying. See United States v. Byrum, 408 U.S. 125 (1972). The IRS has ruled that the general partner's powers do not cause transferred limited partnership interests to be included in his estate under Section 2036 or 2038 because the partner's authority is considered to be limited by his fiduciary obligations to other partners. Letter Rulings 9415007 (August 26, 1994); 9332006 (August 20, 1993); 9131006 (April 30, 1991). In Estate of Strangi v. Comm'r, TC Memo 2003-145, this principle became subject to question for the first time, and the IRS now is aggressively attacking it.

4. Valuation Discounts

a. FLPs and LLCs also can be used in many cases to obtain additional valuation discounts. It should be possible to discount the value of the limited partnership interests for gift and estate tax purposes below the value of the underlying partnership assets because the interests lack marketability and control.

b. As with interests in a closely held corporation, there is no ready market for closely held limited partnership interests. By their very nature, limited partnership interests do not participate in management of the partnership and therefore lack control. These characteristics of a limited partnership interest make it less valuable than the assets transferred upon formation of the partnership.

c. In effect, one can transfer assets to a partnership in order to create a closely held business and take advantage of discounts where they otherwise would not be available. The benefit of these discounts, of course, is that they enable an individual to give away more property.

> **EXAMPLE:** After creating a partnership with $1,000,000 of real estate, cash and securities, Parent gifts $980,000 of LP interests to his children. He discounts those interests by 35% to reflect their lack of marketability and control. This enables Parent to transfer the LP interests for $637,000, and possibly shelter the entire gift with applicable credit amount and annual exclusions.

5. A FLP or LLC can be particularly beneficial with assets such as real estate (held directly or through other partnerships) and business assets, because it permits ownership to remain consolidated while economic interests in the assets are given away in the form of partnership or LLC interests. The entity also can hold other investment assets, such as marketable securities. (A FLP or LLC cannot hold stock in a Subchapter S corporation because a partnership cannot qualify as a Subchapter S shareholder.)

6. A FLP or LLC also may be used to shift future growth in the value of assets to younger generations, permitting that growth to escape transfer tax, while at the same time permitting an individual to retain the income from those assets. This is done by creating an entity with two basic types of interests, (i) those that have a fixed value but a preferred cash flow (“frozen interests”), and (ii) those that share in all future appreciation (“growth interests”). This technique is called a partnership “freeze.” In a FLP structured as a freeze, Parents retain the frozen partnership interests and give the growth interests to their children or grandchildren, either immediately or over time. The goal is to transfer all or substantially all of the growth interests, because as the underlying partnership assets appreciate, that appreciation is allocated only to the growth interests. If descendants hold all of the growth interests, they will benefit from all appreciation of partnership assets, without any transfer tax cost. Parents also would retain small general partnership interests if they wanted to maintain control of the partnership.

V. State Death Taxes. Many states will have a state death tax. In addition, Connecticut has a state gift tax. Planning will have to be done for residents of states with a state death tax and non-residents with property subject to tax in a state with a state death tax.

1. Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

State	**Type of Tax**	**2018 Estate Tax Filing Threshold**
Connecticut	Stand-Alone Estate	$2,600,000
District of Columbia	Estate	$11,180,000
Hawaii	Stand-Alone Estate	$11,180,000
Illinois	Estate	$4,000,000
Iowa	Inheritance	
Kentucky	Inheritance	
Maine	Estate	$11,180,000
Maryland	Estate and Inheritance	$4,000,000
Massachusetts	Estate	$1,000,000
Minnesota	Estate	$2,400,000
Nebraska	County Inheritance	
New Jersey	Inheritance	
New York	Estate	$5,250,000*
Oregon	Estate	$1,000,000
Pennsylvania	Inheritance	
Rhode Island	Estate	$1,537,656
Vermont	Estate	$2,750,000
Washington	Stand-Alone Estate	$2,193,000

* From April 1, 2017 through December 31, 2018, the New York Exemption is $5,250,000. Then, the New York Exemption is scheduled to equal the federal exemption.

2. The effective combined federal and state tax rate for those states that are decoupled from the current federal state death tax varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code Section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect

was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

3. As the following table shows, the marginal federal estate tax rate in 2018 is 33.6% or 34.5% depending on whether the state allows a deduction for the state tax itself.

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2018			
“Coupled” State	40%	0	40%
Ordinary “Decoupled” State	34.5%	13.8%	48.3%
“Decoupled” State/No Deduction	33.6%	16%	49.6%

4. The resulting loss of state revenue and state budgetary shortfalls may lead states that lack a state death tax to enact new state death tax legislation. Two states have already done this. In 2009, Delaware, which had lacked a state death tax since 2005, reinstated its state death tax and then sunsetted the estate tax effective January 1, 2018. Hawaii enacted and estate tax in 2010. Vermont lowered the threshold for its state death tax in 2009. However, it should be noted that some states actually phased out or eliminated their state death taxes at different points. These states included Virginia, Wisconsin, Kansas, Indiana and Oklahoma. New Jersey has repealed its state estate tax, but not its inheritance tax as of January 1, 2018. Delaware, as noted above, has sunsetted its estate tax as of January 1, 2018. Other states have increased their thresholds for state death taxes. These states include Maine, Maryland, New York, and Rhode Island. Minnesota in 2017 enacted a phased-in increase in its exemption to $2.1 million in 2017, $2.4 million in 2018, $2.7 million in 2019, and $3 million in 2020 and thereafter. Connecticut was the latest when on October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the budget for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the federal estate and gift tax exemption in 2020. Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).

5. Not all states that have a state death tax, as noted above, set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of the 2001 Tax Act resulted in a dramatic increase in estate planning complexity for individuals domiciled or owning real or tangible personal property in states with a state death tax. Individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts.

6. The states with a separate state estate or inheritance tax that specifically permit a QTIP election are Illinois, Kentucky (for separate inheritance tax), Maine, Maryland, Massachusetts, Minnesota, Oregon, Pennsylvania (for separate inheritance tax), and Rhode Island (for separate inheritance tax).

7. As noted above, portability of the federal exclusion provides further planning options. A couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $22,400,000 of exclusion in 2018.

8. The failure to shelter property from state estate tax at the first death can increase overall state estate taxes. Currently, only Hawaii permits portability at the state level. A common solution is to use a credit shelter trust for the state threshold amount and then elect portability for the unused exclusion of the first spouse to die.

9. In an era of a greater federal estate tax exemption, individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes by use of state QTIP elections. But the planning is more difficult because of the separate rules often affecting state and federal taxation.

10. Individuals in states with a state estate tax may decide to move to state without a state estate tax to avoid a state estate tax. Likewise, if an individual lives in a state with high state income and property taxes, the new limitations on the deduction for state and local taxes may encourage a move to a state without a state income tax or with lower state income taxes and lower property taxes.

Case Studies

Case Study A:

- Anne is a widow whose husband died in 1995
- She and the children are beneficiaries of a credit shelter trust originally funded with $600,000
- Current value of trust assets = $1,000,000
- Anne's other assets are valued at $3,000,000
- Anne is 89 years old

Case Study B:

- Bob and Sandy are 65. They have two children and four grandchildren. They live in Virginia (no state estate tax).
- They have assets of $10 million
- Current estate plan relies on portability
- Variations:
  - Live in state with estate tax
  - Second marriage, they each have two children and four grandchildren
  - Assets of $20 million
  - Age 85

Case Study C:

- Carlos and Maria are in their 40s
- They have three minor children
- They have assets in excess of $100 million, largely from the sale of a business Maria started and sold
- Both Carlos and Maria are currently involved with new start up businesses

Case Study D:

- Diana is a 85 year old widow whose husband Art died 20 years ago
- Prior to Art's death, they formed an FLP and funded it with real property and securities
- Art's interest in the FLP passed to their 3 children and 3 GST trusts at his death
- Diana made gifts of ~$5 million prior to this year

- Diana still owns 27% of the FLP (FMV ~$4 million)
- Diana has assets outside the FLP (FMV ~5 million)

Case Study E:

- Ed owns a successful construction business worth $20 to $40 million, as well as a large home and other assets
- Ed and Jennifer have 5 children, all minors
- Ed supports his mother Frances, who is 75, has very few assets, and is in relatively poor health

Case Study F:

- Fran founded a manufacturing business taxed as an S-corporation and has, over the years given, and sold 70% to children/grandchildren and (PRIMARILY) to a multi-generation, grantor trust
- Fran, now 87 and retired, holds a note from the grantor trust
- Various family members work for the company and all enjoy distributions
- The company would like to make investments and benefit from the 21% income tax rate

Case Study G:

- George, an accomplished professional athlete, provides life-style advice, conducts fitness consulting and sells various fitness / diet products
- Can the advice/consulting services be separated from the fitness/diet products? What about book sales? Or online course subscriptions about health generally?
- How important is George's personal reputation to the company?
- Can George associate with other similar gurus to "diminish" the importance of his personal skills to the enterprise?

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RECENT DEVELOPMENTS

LEGISLATIVE DEVELOPMENTS

1. IRS Proposes Regulations on Section 199A (August 8, 2018)

IRS proposes new regulations on passthrough deduction under new Section 199A

On August 8, the Internal Revenue Service (IRS) and the Department of the Treasury released proposed regulations on new Section 199A, the 20 percent deduction for qualified business income, added to the Internal Revenue Code of 1986, as amended, by the 2017 Tax Act. Taxpayers and practitioners have eagerly awaited guidance on significant issues that arose with the recent enactment of the new 20 percent deduction. While the proposed regulations answer many questions regarding Section 199A, they leave many significant issues unaddressed.

The proposed regulations under Section 199A provide definitional, computational, and anti-avoidance guidance helpful in determining the appropriate deductible amount. Additionally, the IRS and Treasury proposed regulations under Section 643(f) that contain anti-avoidance provisions with respect to the use of multiple nongrantor trusts to circumvent the purpose of Section 199A. The Section 199A proposed regulations contain six sections, each briefly summarized below.

Background

Section 199A provides generally that taxpayers other than corporations may claim a deduction for 20 percent of their qualified business income from a partnership, S corporation, or sole proprietorship. "Qualified business income" for purposes of Section 199A is defined generally as the net amount of income, gain, deduction, and loss with respect to the qualified trade or business, excluding certain investment-related income and guaranteed payments to partners in a partnership. A "qualified trade or business" is defined generally as any trade or business except the trade or business of performing services as an employee and any specified service trade or business (SSTB).

The deduction under Section 199A is limited generally to the greater of: (1) 50 percent of the W-2 wages of the trade or business for the taxable year, or (2) the sum of 25 percent of such wages and 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property for the taxable year (referred to awkwardly in the proposed regulations as "UBIA of qualified property"). The W-2 wage and UBIA of qualified property limitations do not apply to taxpayers with a taxable income of less than $157,500 ($315,000 for married couples filing jointly) and is phased in for taxpayers with taxable income above that threshold amount. Finally, the Section 199A deduction cannot exceed the taxpayer's taxable income over net capital gain for the tax year.

Operational Rules

The first Section of the proposed regulations under Section 199A provides guidance on the determination of the Section 199A deduction generally. The proposed regulations clarify that, for purposes of Section 199A, the term "trade or business" should be interpreted in a manner consistent with the guidance under Section 162, which provides a deduction for ordinary and necessary business expenses. The proposed regulations under Section 199A, however, expand the traditional definition under Section 162 to include certain rental or licensing of property to related parties under common control.

This first Section also provides guidance on computing the deduction for a taxpayer that has taxable income above, at, or below the threshold amount for applying the W-2 wage and UBIA of qualified property limitations. In doing so, the IRS and Treasury prescribe computational rules, including rules for determining carryover losses and for the treatment of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

Finally, the first Section of the proposed regulations provides that the Section 199A deduction is applied at the partner or shareholder level. The deduction does not affect the adjusted basis of a partner's interest in a partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

Determination of W-2 Wages and the UBIA of Qualified Property

The second section of the proposed regulations prescribes rules for determining W-2 wages and the UBIA of qualified property. The proposed regulations provide that W-2 wages of a qualified trade or business are determined generally using the rules that applied under former Section 199 with respect to the domestic production activities deduction. The IRS and Treasury state in the preamble of the proposed Section 199A regulations that Notice 2018-64, issued concurrently with the proposed regulations, provides three methods for calculating the W-2 wages of a qualified trade or business.

Additionally, the second section of the proposed regulations addresses many issues concerning the UBIA of qualified property, including its allocation among relevant passthrough entities, subsequent improvements to the qualified property, and the effect of certain nonrecognition transactions (for example, like-kind exchanges). The regulations put in place guardrails to prevent taxpayers from gaming the system. For example, the proposed regulations indicate that property is not qualified property if a taxpayer acquires and disposes of the property in a short period unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was not to increase the Section 199A deduction.

Qualified REIT Dividends and Qualified Publicly Traded Partnership Income

The third section of the proposed regulations restates the definition of qualified business income (QBI) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified PTP income. The regulations describe in further detail the exclusions from QBI, including capital gains, interest income, reasonable compensation, and guaranteed payments. With respect to qualified REIT dividends, the proposed regulations contain an anti-abuse rule to prevent dividend-stripping and similar transactions aimed at increasing the qualified REIT dividends without having a corresponding economic exposure.

Aggregation Rules

The fourth section of the proposed regulations addresses rules for aggregating multiple trades or businesses for the purposes of applying the computational rules of Section 199A. Commentators urged the IRS to apply the grouping rules for determining passive activity loss and credit limitation rules under Section 469. The IRS concluded that the rules under Section 469 were inappropriate for purposes of Section 199A, but did agree with commentators that aggregation should be permitted.

The proposed regulations create a four-part test for aggregation. First, each trade or business a taxpayer proposes to aggregate must itself be a trade or business as defined by the proposed regulations. Second, the same person, or group of persons, must own, directly or indirectly, a majority interest in each of the businesses for the majority of the taxable year. The proposed regulations provide rules allowing for family attribution for this purpose. Third, none of the trades or businesses can be an SSTB. Finally, the trade or business must meet at least two of the three following characteristics:

> (1) The businesses provide products and services that are the same or typically provided together.
>
> (2) The businesses share facilities or significant centralized elements.
>
> (3) The businesses are operated in coordination with each other.

Under the proposed regulations, an individual taxpayer may aggregate trades or businesses operated through multiple passthrough entities; however, the taxpayer must determine the QBI, W-2 wages, and UBIA of qualified property for each trade or business separately before applying the aggregation rules. The proposed regulations prohibit vertical aggregation of trades or businesses conducted through tiered partnerships.

Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee

The fifth section of the proposed regulations contains substantial guidance on the definition of an SSTB. Under Section 199A, if a trade or business is an SSTB, none of its items are taken into account for determining a taxpayer’s QBI. A taxpayer who owns an SSTB conducted through an entity, such as an S corporation or partnership, is treated as engaged in an SSTB for purposes of Section 199A, regardless of the taxpayer’s actual level of participation in the trade or business.

Notwithstanding the general rule, taxpayers with taxable income of less than $157,500 ($315,000 for married couples filing jointly) may claim a deduction under Section 199A for QBI received from an SSTB. The Section 199A deduction phases out for taxpayers with taxable incomes over this threshold amount. If a trade or business is conducted by a passthrough entity, the phase-out threshold is determined at the individual, trust, or estate level, not at the level of the passthrough entity. Accordingly, a passthrough entity conducting an SSTB could have taxable income below the threshold amount but have no owners eligible for a Section 199A deduction because each of them has taxable income above the threshold amount (plus $50,000 or $100,000 in the case of a married couple filing jointly).

The proposed regulations also attempt to combat what commentators have called the “crack and pack” strategy. Under this strategy, a business that would otherwise be an SSTB separates all its administrative functions into a separate entity to qualify that separate entity for the Section 199A deduction. To minimize the potential for this abuse, the proposed regulations provide that an SSTB includes any trade or business with 50 percent or more common ownership that provides 80 percent or more of its services to an SSTB.

The proposed regulations contain a lengthy and detailed definition of an SSTB. Generally, the proposed regulations state that the existing guidance defining a "qualified personal service corporation" under Sections 448 and 1202 informs the definition of an SSTB under Section 199A. Pursuant to Section 199A(d)(2)(A), which incorporates the rules of Section 1202(e)(3)(A), an SSTB is any trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, or trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. The proposed regulations limit "reputation or skill" to trades or businesses involving the receipt of income for endorsing products or services, licensing or receiving income for the use of an individual's publicity rights, or receiving appearance fees.

The common law and statutory rules used to determine whether an individual is an employee for federal employment tax purposes apply to determining whether an individual is engaged in the trade or business of performing services as an employee for purposes of Section 199A. The proposed regulations also create a presumption that an individual who was treated as an employee for federal income tax purposes but is subsequently treated as other than an employee with respect to the same services is still engaged in the trade or business of performing services as an employee for purposes of Section 199A. The presumption attempts to prevent taxpayers from reclassifying employees as independent contractors in order to claim a Section 199A deduction.

Special Rules for Passthrough Entities, Publicly Traded Partnerships, Trusts, and Estates

The sixth section of the proposed regulations contains special rules for passthrough entities, PTPs, nongrantor trusts, and estates. Passthrough entities, including S corporations and entities taxable as partnerships for federal income tax purposes, cannot claim a deduction under Section 199A. Any passthrough entity conducting a trade or business, along with any PTP conducting a trade or business, must report all relevant information — including QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income — to its owners so they may determine the amount of their respective Section 199A deductions.

The proposed regulations require that a nongrantor trust or estate conducting a trade or business allocate QBI, expenses properly allocable to the trade or business, W-2 wages, and UBIA of qualified property among the trust or estate and its beneficiaries. The allocation is based on the ratio that the distributable net income (DNI) distributed or deemed distributed to each beneficiary bears to the trust's or estate's total DNI for the taxable year. Any DNI not distributed is allocated to the nongrantor trust or estate itself. UBIA of qualified property is allocated without taking into account how depreciation deductions are allocated among the beneficiaries under Section 643(c). When calculating the threshold amount for purposes of applying the W-2 wage and UBIA limitations, taxable income is computed at the trust or estate level without taking into account any distributions of DNI.

For purposes of the proposed Section 199A regulations, a qualified subchapter S trust (QSST) is treated as a grantor trust. The individual treated as the owner of the QSST is treated as having received QBI directly from the trade or business and not through the QSST. The IRS and Treasury are requesting comments regarding whether a taxable recipient of an annuity or unitrust interest in a charitable remainder trust (CRT) should be eligible for a Section 199A deduction to the extent the taxpayer receives QBI from the CRT.

Anti-avoidance Guidance for Multiple Nongrantor Trusts

In addition to proposing regulations under Section 199A, the IRS and Treasury proposed regulations under Section 643(f) designed to prevent taxpayers from manipulating the Section 199A deduction using multiple nongrantor trusts. Section 643(f) allows Treasury to prescribe regulations to prevent taxpayers from establishing multiple nongrantor trusts to avoid federal income tax. The proposed regulations under Section 643(f) provide that when two or more trusts have the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a purpose of such trusts is to avoid federal income tax, all of such trusts will be treated as a single trust for federal income tax purposes. Absent this anti-abuse rule, taxpayers could own a trade or business through multiple nongrantor trusts such that each trust would have taxable income below the threshold amount for applying the W-2 wage and UBIA limitations on the Section 199A deduction.

2. Notice 2018-54, 2018-24 I.R.B. 750 (May 23, 2018)

IRS provides guidance on certain payments made in exchange for state and local tax credits

The purpose of this notice is to inform taxpayers that the Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

The 2017 Tax Act limited an individual taxpayer's deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000. State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years from 2018 through 2025. In response to this new limitation, some state legislatures are considering or have adopted proposals that would allow taxpayers the make transfers to funds controlled by state or local governments or other specified transfers in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of the proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes while using the same transfers to satisfy state or local tax liabilities.

The notice warns taxpayers that despite these state efforts to circumvent the new $10,000 limitation on the deduction of state and local taxes, they should be mindful that federal law controls the proper characterization of payments for federal income tax purposes. Proposed regulations will be issued to make it clear that the requirements of the Internal Revenue Code, informed by substance over form principles, will govern the federal income tax treatment of such transfers.

3. Press Release: Treasury Issues Proposed Rule on Charitable Contributions and State and Local Tax Credits (August 23, 2018)

Department of Treasury issues proposed rule on federal income tax treatment of payments and property transfers under state and local tax credit programs

The Treasury Department released this proposed rule to prevent charitable contributions from being used to circumvent the new limitation on state and local taxation under the 2017 Tax Act. The 2017 Tax Act limited the amount of state and local taxes that an individual could deduct to

$10,000 per year. Several states have enacted or are considering tax credit programs to "circumvent" the $10,000 limit of the 2017 Tax Act.

The Treasury Department stated that the proposed rule is a straightforward application of a long-standing principal of tax law: when a taxpayer receives a valuable benefit in return for a donation to charity, the taxpayer can deduct only the net value of the donation of a charitable contribution. The rule applies that quid pro quo principle to state tax benefits provided to the donor in return for contributions.

The press release gives the following example: if a state grants a 50 percent credit and the taxpayer contributes $1,000, the allowable charitable contribution may not exceed $500. The proposed rule provides an exception for dollar-for-dollar state and local tax deductions and tax credits of no more than 15 percent of the payment amount of the fair market value of the property transferred. These guidelines will apply to both new and existing tax credit programs.

The press release also noted that because of the increase in the standard deduction of the 2017 Tax Act the Treasury Department projects that 90 percent of taxpayers will not itemize under the new tax law. It also estimates that approximately 5 percent of taxpayers will itemize and have state and local income tax deductions above the $10,000 cap. The Treasury Department also expects that only about 1 percent of taxpayers will see an effect on the tax benefits for donations to school choice tax credit programs.

4. 2017–2018 Priority Guidance Plan (October 20, 2017)

Treasury Department and the Internal Revenue Service release their 2017–18 priority guidance plan

On October 20, 2017, Treasury Department and the Internal Revenue Service released their 2017–18 Priority Guidance Plan which lists those projects which the IRS hopes to complete during the period from July 1, 2017 through June 30, 2018.

Part 1 of the Plan, "Identifying and Reducing Regulatory Burdens," focuses on the eight regulations from 2016 that were identified pursuant to Executive Order 13789 (April 21, 2017) and the intended actions with respect to those regulations. Executive Order 13789 directed the Secretary of the Treasury to identify all significant tax regulations issued on or after January 1, 2016 that (i) imposed an undue financial burden on taxpayers, (ii) added undue complexity to the federal tax laws; or (iii) exceeded the statutory authority of the Internal Revenue Code. An interim report was issued by the Treasury Department on June 22, 2017 which identified eight regulations for review including the proposed regulations on Section 2704 that were published on August 2, 2016. This report was also contained in Notice 2017-38, 2017-30 I.R.B. 147 (July 7, 2017).On October 2, 2017, the Treasury Department in a report entitled "Identifying and Reducing Tax Regulatory Burdens," announced the withdrawal of the proposed Section 2704 regulation.

Item 1 of Part 1 is the withdrawal on October 2, 2017 of the proposed Section 2704 Regulations regarding restrictions on the liquidation of an interest for estate, gift, and generation-skipping purposes.

Part 2 of the Plan, "Near-Term Burden Reduction," lists those items that the IRS believes can be completed in the remaining 8 ½ months of the plan year. The two estate and gift tax related items are "Final regulations under Section 2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption" and finalization of the consistent basis regulations for estate tax purposes under Sections 1014(f) and 6035.

Part 3 of the Plan describes projects related to the implementation of the new statutory partnership audit rules.

Part 4 of the Plan, "General Guidance," describes specific projects by subject area that will be the focus of the balance of the IRS's efforts during the plan year. Part 4 contains the following three items under the heading of "Gifts and Estates and Trusts" for the years 2017 to 2018:

1. Guidance on basis of grantor trust assets at death under Section 1014.

2. Final regulations under Section 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.

3. Guidance under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

The following items were not carried over from the 2016-2017 Priority Guidance Plan:

1. Guidance on qualified contingencies of charitable remainder trusts under Section 664. The IRS did issue Revenue Procedure, 2016-42, 2016-34 I.R. B. 26 on August 9, 2016 which provided a sample provision to permit a charitable remainder annuity trust to qualify even if it did not meet the probability of exhaustion test.

2. Guidance on the definition of income for spousal support trusts under Section 682.

3. Revenue procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability. Revenue Procedure 2016-49, 2016-49 2016-42 I.R.B. 1 to address this was issued on September 27, 2016.

4. Guidance on the valuation of promissory notes for transfer tax purposes under Sections 2031, 2033, 2512, and 7872.

5. Guidance on the gift tax effect of defined value formula clauses under Sections 2512 and 2511.

6. Guidance under Sections 2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts.

7. Regulations under Section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. Proposed regulations were issued on August 2, 2016 and withdrawn on October 2, 2017 as noted in Part 1 of the Plan.

8. Guidance under Section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

The reduction in the number of items in the 2017-2018 Priority Guidance Plan could be due to one or more factors including (i) a reduction in the IRS's personnel and budget which does not permit the IRS to work on as many items as in the past; (ii) a belief in the leadership of the Treasury Department and other branches of the administration that the estate tax will be repealed as part of tax reform and, thus, work on projects involving the estate tax is unnecessary; (iii) a furtherance of the stated policy of the Trump Administration to reduce the number of regulations; or (iv) simply a recognition by the IRS of its inability to address these issues during the plan year although they may be addressed later.

5. Revenue Procedure 2017-58, 2017-45 I.R.B. 19 (October 19, 2017)

Inflation adjustments for 2018 announced

This Revenue Procedure provides the inflation adjustments for 2018. Some important adjustments in the estate, gift, generation-skipping and fiduciary income tax areas are:

1. The gift tax annual exclusion is increased to $15,000.

2. The estate and gift tax applicable exclusion amount is increased to $5,600,000.

3. For an estate of a decedent dying in 2018, the aggregate decrease in the value of qualified property for which a special use valuation is made under Section 2032A is increased to $1,140,000.

4. The gift tax annual exclusion amount for non-citizen spouses is increased to $152,000.

5. Recipients of gifts from certain foreign individuals must report these gifts if the value of the gifts in 2018 is $16,111.

6. The kiddie tax exemption remains at $1,050.

6. Letter Rulings on Extension of Time to Make Portability Election

Extension of time to make portability election permitted

Numerous letter rulings (too numerous to list) have been, and continue to be, issued on the same fact pattern. Decedent's estate was less than the applicable exclusion amount in the year of decedent's death. Decedent's estate failed to file a federal estate tax return to make the portability election and discovered its failure to elect portability after the due date for making the election. In each letter ruling, the IRS determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time to make an election were met. Under this regulation, an extension of time will be granted if a taxpayer is deemed to have acted reasonably and in good faith. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer if the tax professional failed to make or advise the taxpayer to make the election. In 2017, the standard fee for a letter ruling requiring an extension of time under Treas. Reg. § 301.9100-3 is $10,000. Revenue Procedure 2018-1, 2018-1 IRB 1.

7. Notice 2017-12, 2017-5 I.R.B 742 (January 6, 2017)

IRS provides guidance on methods available to confirm closing of the estate tax return examination

Prior to June 1, 2015, the IRS issued estate tax closing letters for every estate tax return filed. However, the IRS changed its policies for returns filed on or after June 1, 2015. The IRS will now issue a closing letter for an estate only if the estate requests such a closing letter. The request of an estate for a closing letter is to be made four months after the filing of the estate tax return.

The IRS in this Notice stated that it had previously announced that it would no longer issue estate tax closing letters as a matter of course and noted that different state and local agencies have come to rely upon closing letters for confirmation that the IRS has closed its examination of the estate. In the absence of a closing letter, an account transcript, which is a computer generated report reflecting current account information can be relied upon a substitute for the closing letter. However, the IRS noted that a closing letter is not equal to a closing agreement and that under certain circumstances, the IRS can reopen the examination. A taxpayer can confirm the closing of the IRS's examination of an estate tax return by requesting a transcript of the account. If the account transcript contains a transaction code of "421," this, similar to the receipt of an estate tax closing letter, will confirm the closing of the IRS's examination of the return.

MARITAL DEDUCTION

8. Letter Ruling 201751005 (Issued September 18, 2017; Released December 22, 2017)

IRS grants extension of time to make QTIP election

The decedent, upon his death, provided that his estate would be divided into a bypass trust, a marital trust, and a survivor's trust. The marital trust qualified for the QTIP marital deduction. The executor of the decedent's estate was a CPA. The executor's accounting firm prepared the Form 706 for the decedent's estate. However, the executor misinterpreted the terms of the trust and failed to make the QTIP election with respect to the marital trust. The executor requested an extension of time under Treas. Reg. §§ 301.9100-1 and 301.9100-3 to make the QTIP election to treat the marital trust as QTIP property.

The IRS granted the request for an extension of time to make the QTIP marital deduction election. Treas. Reg. § 301.9100-3 provides that an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make the election or failed to advise the taxpayer to make the election. One question not addressed in this letter ruling is that the executor was a CPA himself or herself and therefore might be considered a qualified tax professional, although his or her area of expertise may not have been estate, gift, and generation-skipping taxes.

GIFTS

9. Karen S. True v. Commissioner, Tax Court Docket No. 21896-16 and H. A. True III v. Commissioner, Tax Court Docket No. 21897-16 (Petitions filed October 11, 2016)

IRS attacks use of Wandry clause in gift and sale of interests in a family business

In the True v. Commissioner case, Husband gave interests in a family business to one of his daughters. At the same time, he sold interests in the family business to his three children and a trust. Husband obtained appraisals from FMV which the court noted is a recognized and reputable national appraisal firm. Since Husband and Wife split the gift, any gift was considered made one-half by each spouse.

When the gifts of the interests in the family business were made to the daughter, the transfer agreement provided that if the value of the interests transferred to the daughter were determined to be worth more than $34,044,838 for federal gift tax purposes, then the interests owned by the daughter would be adjusted so that the value of the gift remained at $34,044,838 and the daughter would be treated as having purchased the ownership interests that were removed from the gift. Thus, the transfer documents utilized adjustment provisions to fix the value of the interests given to the daughter at a specific dollar value similar to the adjustment clause upheld by the Tax Court in Wandry v. Commissioner, T.C. Memo 2012-88 and with which decision the Service disagrees.

With respect to the interests that were sold to that daughter and the other two children and a trust, the transfer documents provided that if the interests sold were undervalued by FMV for federal gift tax purposes, the purchase price would be increased to reflect the fair market value as finally determined for gift tax purposes.

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Husband and Wife. Husband and Wife have countered that the valuations are correct. However, if the transferred interests are determined to have a higher value, no gift should result because of the adjustment provisions contained in the transfer agreement. These two cases may help determine the future validity and usefulness of Wandry adjustment clauses.

10. Letter Rulings 201744006 and 201744007 (Issued July 26, 2017; Released November 3, 2017)

Contributions of property to trust by grantors is not a completed gift subject to gift tax

These rulings are some of the latest rulings dealing with incomplete non-grantor trusts that are established in states with state income taxes by residents of those states to avoid state income taxes, usually on the disposition of highly appreciated assets. While these transfers are designed to avoid income taxes, they are not designed to avoid estate taxes when the grantors pass away. These letter rulings dealt with trusts established by residents of a community property state.

In these letter rulings, Husband and Wife created an irrevocable trust for the benefit of themselves, their issue, and each of their fathers. The trust had a corporate trustee as the sole trustee. The grantors, as noted above, resided in a community property state.

Under the terms of the trust, the trustee could distribute income and principal to the beneficiaries and either or both of the grantors as appointed by the Power of Appointment Committee. After the death of the predeceased grantor and until the death of the surviving grantor, the trustee could distribute income and principal to the beneficiaries and the surviving grantor as the Power of Appointment Committee appointed. Any appointment, direction, determination, or action by the Power of Appointment Committee required the unanimous written consent of all members of the Power of Appointment Committee or the written consent of both of the grantors and a majority of the then serving members of the Power of Appointment Committee. The members of the Power of Appointment Committee served and acted in a non-fiduciary capacity. The Power of Appointment Committee consisted initially of the grantors' fathers, and guardians who had the legal authority to act on behalf of the grantors' two minor children.

Each grantor had the power in a non-fiduciary capacity to appoint any principal to any one or more of the issue. The predeceased grantor had a broad special power of appointment over the predeceased grantor's entire interest in the property of the trust. Upon the death of the predeceased grantor, the predeceased grantor's one-half interest in the trust that was not appointed was distributed to members of the committee and the grantor's issue. Upon the death of the surviving grantor, the surviving grantor's interest would be distributed pursuant to a broad special power of appointment, otherwise to the members of the committee and the grantor's issue.

Six rulings were requested:

1. The trust would be treated as a non-grantor trust for income tax purposes.

2. The contribution of property to the trust would not be a completed gift subject to gift tax.

3. Any distribution of property by the Power of Appointment Committee to either grantor would not be a completed gift.

4. Any distribution of property by the Power of Appointment Committee to a beneficiary other than the grantors would not be a completed gift by any members of the committee.

5. No member of the Power of Appointment Committee would be considered to have a taxable general power of appointment which would cause the inclusion of any property held in the trust in his or her estate.

6. The basis of all community property in the trust on the date of the death of the predeceased grantor would be stepped up to the fair market value on the date of death of the predeceased grantor.

With respect to the first request, the Service, as it has in previous rulings dealing with income tax consequences of incomplete non-grantor trusts, ruled that the grantor would not be treated as an owner of the trust under Sections 673, 674, 676, 677, or 679 so long as the trust remained a domestic trust and the Power of Appointment Committee remained in existence. The IRS also concluded that none of the circumstances would cause the administrative controls to be considered exercisable primarily for the benefit of either grantor under Section 675. For that reason, the circumstances attendant on the operations of the trust would determine whether either grantor was treated as the owner of any portion of the trust for Section 675 and therefore that portion would be a grantor trust for income tax purposes. The federal income tax returns of the parties would have to be examined to determine the income tax consequences. None of the members of the Power of Appointment Committee would be treated as an owner of the trust for income tax purposes, because none of the members had a power exercisable by himself or herself to vest trust income or corpus in himself or herself under Section 678(a).

With respect to the second and third ruling requests, the Service concluded that a contribution of property to the trust by the grantors was an incomplete gift. Any distribution from the trust to a beneficiary would be a completed gift at the time of distribution and treated as being made one-half by each grantor. Upon either grantor's death, the fair market value of his or her interest in the property and the trust would be included in the grantor's estate for estate tax purposes. Any distribution from the trust by the grantor was merely a return of each grantor's property and was not a gift. Upon the death of the predeceased spouse, the fair market value of the predeceased spouse's interest in the trust would be included in the predeceased spouse's estate. Upon the death of the surviving grantor, the fair market value of the balance of the trust would be included in the surviving grantor's gross estate for federal estate tax purposes.

With respect to fourth and fifth ruling requests, the Service concluded that any distribution of property by the Power of Appointment Committee to any beneficiary of the trust other than the grantors was not a completed gift by any member of the committee. In addition, the powers held by the committee members were not taxable general powers of appointment.

With respect to the sixth ruling request, the Service concluded that the basis of all community property in the trust on the date of death of the predeceased grantor would be stepped up to the fair market value of the property on the date of death of the predeceased grantor. This was based on Section 1014(b)(6), which provides that the surviving spouse's one-half share of community property is considered for purposes of the step-up in basis rules to have been acquired from or to have passed from the deceased spouse if at least one-half of the whole of the community interest in such property is included in determining the value of the deceased spouse's gross estate.

11. Letter Ruling 201803003 (Issued October 6, 2017; Released January 9, 2018)

Proposed trust modifications will not trigger gift or generation-skipping tax

An irrevocable trust was created prior to October 22, 1942 by parents for the benefit of Daughter. The Daughter's only right was to receive distributions of net earnings, but not principal, awarded to her by the trustee with the consent of the advisory board of the trust and to distribution of the trust estate made by the trustee at the termination of the trust. At Daughter's death, her equitable interest was to pass to and vest in her heirs in accordance with the laws of descent and distribution then in force. The trust was to continue for Daughter's life and for a period of 21 years after her death at which time the trust would terminate and the trust corpus would be distributed to the beneficiaries.

Because of a planned disclaimer, certain of the children and grandchildren of Daughter had sought a declaratory judgment concerning the impact of their planned disclaimers. The court ruled that Daughter and the successor beneficiaries all had a testamentary general power of appointment. A pre October 22, 1942 power of appointment only has adverse estate tax consequences if it is exercised. Upon the death of Daughter or successor beneficiary, the heirs at law of that beneficiary would succeed to the beneficiary's interest in the trust. The court also ruled that after Daughter's death, each successor beneficiary would have three separate beneficial interests:

1. An income interest for 21 years after Daughter's death;

2. The remainder interest which vested in possession 21 years after Daughter's death; and

3. A pre-1942 general power of appointment.

The court ruled that each of those interests could be disclaimed independently of others.

Several years later, Daughter proposed to partially release her general power of appointment to restrict the power in two respects. First, the power was to be exercisable only in favor of the Daughter's estate. Second, the power could only be appointed to take effect after her death. The intention of Daughter was to allow her power of appointment over the trust to lapse at her death.

Subsequently, the trustee petitioned the supervising court, with the consent of the Daughter and other beneficiaries, to provide that when the trust terminated 21 years after the death of Daughter, any share distributed to a beneficiary under a specified age was to be held in a continuing trust until that beneficiary reached the specified age. If that beneficiary survived Daughter but died before reaching the specified age, the beneficiary would have a general testamentary power of appointment causing the property to be included in the beneficiary's estate. The later petition also requested the court to modify the trust to allow for the administration of the separate trusts created after the Daughter's death.

The taxpayer requested the following rulings:

1. The power of appointment granted to the great grandchildren who succeeded to the Daughter's interest in the trust would be considered a pre-October 22, 1942 power of appointment and the complete release or lapse of that power of appointment would not have any adverse estate, gift, or GST tax purposes.

2. The proposed disclaimer by any one or more of the great grandchildren would be a qualified disclaimer under Section 2518 and would not have any adverse gift tax or estate tax consequences to the disclaimants and would not result in the loss of the GST exempt status of the trust.

3. The assets of a continuing trust created pursuant to proposed modification after Daughter's death would be included in the estate of the beneficiary if the beneficiary died before the termination of the continuing trust.

4. The proposed construction of the trust would not cause the trust to be subject to GST tax.

5. The proposed construction of the trust would not result in a taxable gift by any of the beneficiaries of the trust.

With respect to the first ruling request, the Daughter had a pre-October 22, 1942 general power of appointment to which the grandchildren would succeed when the Daughter dies. To the extent that any grandchild disclaimed his or her interest in that power of appointment or died during the 21 year period following Daughter's death, some great grandchildren might succeed to her power of appointment. Based on the regulations to Section 2041, the power of appointment held by the great grandchildren and more remote beneficiaries would be considered a power created before October 22, 1942 and consequently the release or lapse of such a power would not treated as the exercise of the power and would have no adverse estate or gift tax consequences.

With respect to the second ruling request, Daughter's heirs cannot succeed to any interest in the trust until Daughter's death pursuant to the terms of the trust. Consequently, Daughter's great grandchildren could disclaim their interest and there would be no adverse estate or gift tax consequences.

With respect to the third and fourth ruling requests, the proposed modifications would not have any adverse generation-skipping tax consequences. The modification would fall within the scope of Treas. Reg. 26.2601-1(b)(4)(i)(D)(1) which provides that a modification of the governing instrument of an exempt trust is valid under applicable state law and will not have adverse GST consequences when the modification does not shift a beneficial interest to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification and the modification does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in the original trust. That was the case here.

With respect to the fifth ruling request, because the proposed construction of the trust clarified ambiguous terms of the trust and reflected the rights of the party under applicable law, the proposed construction of the trust would not result in a taxable gift by any of the beneficiaries of the trust.

12. Letter Ruling 201808002 (Issued November 16, 2017; Released February 23, 2018)

Service rules on gift tax consequences of gift of life estate interest in pre-October 9, 1990 transaction

Prior to the enactment of Chapter 14 in 1990, husband, wife, and their six children purchased real estate from an unrelated party for the property's fair market value. Husband, wife, and each of the children executed an agreement whereby husband, wife, and each of the children paid the actuarial value of their respective interests from their own resources and none of the six children used any funds acquired from their parents to acquire their respective interests. Under the agreement, wife acquired a life interest in the use of and income from the real property, husband acquired a life interest in the use of and income from the real property that became effective upon the death of the wife, and each of the children had a 1/6th undivided interest in the remainder.

The life tenants wished to give a geographically defined portion of the acreage of their life interest in the real property to the children. As a result, the six children would become the outright owners of that geographically defined real estate.

The taxpayers requested rulings that:

1. The remaining acreage of the real property after the transaction would continue to be treated as resulting from a pre-October 9, 1990 transfer for purposes of the application of Chapter 14.

2. The proposed gifts by the life tenants would be treated as gifts for federal gift tax purposes.

The proposed gifts by the life tenants would not result in any portion of the real property being included in the gross estate of either life tenant for estate tax purposes.

The Service first ruled that the conveyance of the real estate by the life tenants would be treated as gifts for federal gift tax purposes and that the gifts would be valued using the actuarial value of the individual life estate interests determined by the application of the appropriate Section 7520 rate. In addition, the life tenants would not be considered to retain any interest in, or any right to alter or revoke, or any reversion in the portion of the real estate that was conveyed to the remainder beneficiaries and that the transaction would not result in any adverse estate tax consequences to wife and husband. The Service held that the transaction would not be subject to the application of Chapter 14.

13. Letter Ruling 201825003 (Issued March 9, 2018; Released June 22, 2018)

Transfer of the legal title, naked ownership, and remainder interest in and to artwork as defined by the deed of transfer is a completed gift for gift tax purposes

Taxpayer and spouse owned an art collection. The taxpayer as a result of the spouse's death, became the sole owner of the artwork. Prior to the spouse's death, the taxpayer and the spouse entered into a deed of transfer with two museums outside of the United States under which they agreed to donate the artwork with the possession of the artwork by the museums to occur on the death of the second to die and spouse.

The deed of transfer provided that the taxpayers granted to the museums the legal title, naked ownership and remainder interest in and to the artwork. It also provided that the taxpayer expressly reserved a life interest and usufruct in and to the artwork which would automatically expire on the death of the taxpayers.

The deed provided the parties intended for the transfer not to qualify for gift tax purposes on the basis that the taxpayer was not releasing dominion and control over the artwork until death. If the taxpayer received a favorable ruling from the IRS of the gift tax treatment, the donation is deemed to take effect as of the day of the favorable ruling. Certain conditions were imposed in the deed of transfer. The museums were to comply with the requirements regarding the housing, display, and exhibition of the artwork. The museums must not become privately owned and the tax laws must not change to cause the taxpayer to become subject to taxation in the country, during the taxpayer's life or upon death, in connection with the transfer of the artwork if the artwork was to be transferred to museums in a country other than the United States.

The IRS stated that upon the effective date of the deed of trust, the taxpayer would transfer legal title, naked ownership and the remainder interests of the artwork to the museums. During the period of the life interest and usufruct, the taxpayer would not sell or otherwise dispose of any of the artwork. The taxpayer retained no power to change the disposition of the artwork and was barred from doing so under the deed of trust. Even though the transfer of the artwork was subject to several conditions subsequent, the conditions that would cause a revocation of the transfer were not dependent on any act of the taxpayer. Consequently, the taxpayer's grant to the museums of the legal title, naked ownership, and remainder interest to the artwork would be a completed gift for gift tax purposes.

ESTATE INCLUSION

14. Estate of Sommers v. Commissioner, 149 T.C. No. 8 (2017)

Tax Court denies estate tax deduction for gift tax owed at death by decedent on gifts to decedent's nieces

In an earlier case, Estate of Sommers v. Commissioner, T.C. Memo 2013-8, the Tax Court held that a decedent, who then lived in Indiana, made valid gifts of interests in a limited liability company holding artwork to his three nieces in December 2001 and January 2002. Decedent subsequently moved to New Jersey and died in November 2002. Decedent's wife succeeded to the property she owned jointly with decedent and decedent's will gave all of his estate remaining after the payment of debts and expenses to his wife. The wife subsequently died and her beneficiaries became the ultimate beneficiaries of the estate's assets. In accordance with the agreements governing their gifts from decedent, the three nieces paid the gift tax due on those gifts. The estate filed three motions for partial summary judgement seeking determinations that:

1. The gift tax owed at decedent's death on his gifts to nieces was deductible under Section 2053;

2. The estate was entitled to a Section 2056 marital deduction equal to the value of decedent's non probate property that the wife received or to which she succeeded that, under applicable New Jersey law, was exempt from decedent's debts and the expenses of the estate; and

3. Any federal estate tax due must be apportioned to the nieces and thus did not reduce the estate's marital deduction.

The three nieces filed their own motion for partial summary judgment that none of the estate tax liability could be apportioned to them.

In 2001, decedent, who was then divorced from his wife, sought legal advice on how to transfer works from his art collection to the three nieces who were then his closest living relatives. His attorneys offered two proposals to reduce or eliminate gift tax on the gift of the artwork. First the attorneys recommended that decedent transfer the artwork to a newly formed limited liability company and then make gifts of the units representing ownership interests in the entity to the nieces. This recommendation assumed that, as a result of applicable valuation discounts, the appraised value of the units in the limited liability company would be less than the value of the artwork they represented. The attorneys also recommended that the decedent make the intended gifts in two stages, transferring some units to each niece on or before December 31, 2001 and the rest thereafter. Spreading the gifts across two years would increase the portions of the gifts that could be covered by the gift tax annual exclusion. It would also allow the decedent to use the increased applicable exclusion amount of $1 million that was scheduled to take effect in 2002. Decedent wanted to transfer the maximum number of units possible to the nieces without incurring gift tax in 2001 and then complete the gifts of the units in 2002.

In accordance with the plan, decedent transferred the artwork to the LLC and executed two sets of gift and acceptance agreements with his nieces. The first agreement was dated December 27, 2001 and the second was dated January 4, 2002. When decedent and his nieces initially executed the agreements, blanks were left for the number of units for each transfer pending completion of an appraisal of the artwork. The appraisal, when completed in March 2002, assigned a value to the artwork that led decedent's attorneys to conclude that dividing the transfers of the units across the end of 2001 would not allow for the complete avoidance of gift tax. The nieces then agreed to pay any gift tax resulting from the 2002 transfers and the gift and acceptance agreements were completed by filling in the blanks for the numbered units covered by each transfer.

In addition, decedent's nieces amended each of the 2002 agreements to add a provision pursuant to which each niece "agreed to pay the gift taxes, if any, relating to the gift of the units, including without limitation, any gift taxes, penalties, and interest that may later correctly be assessed." None of the 2002 agreements referred to apportionment of any federal estate tax liability resulting from the gifts. While none of the agreements provided for the assumption by the nieces of any liability other than gift tax, none of the agreements specifically exculpated the nieces from other liabilities.

In April 2002, decedent executed his will that directed his executor (his then ex-wife) to pay all of his just debts including funeral and burial costs and expenses of his last illness and all costs and expenses of administering and settling his estate. The nieces received all of decedent's estate remaining after payment of those debts.

In June 2002 shortly before remarrying his ex-wife, decedent initiated litigation in Indiana against his nieces challenging the validity of the purported gifts and seeking return of the artwork. The litigation in Indiana and similar litigation his ex-wife initiated in New Jersey after decedent's death on November 1, 2002 ultimately upheld the validity of the gifts. On the federal estate tax return, decedent's estate took a marital deduction of $3,330,510.43 and after taking account of all deductions, the taxable estate was $507.34. On examination, the IRS increased taxable estate from $507.34 to $1,092,106.68. This increase of $1,091,599.34 reflected three adjustments that followed from the IRS's determination that decedent's transfers of units were valid gifts. First, the IRS included the gift tax determined to be due as a result of the 2002 gifts. This amount of $510,648 was included because decedent made the gifts less than three years before his death. Second, the IRS excluded from decedent's gross estate the $1,750,000 value that the estate had assigned to the artwork that decedent had transferred to LLC. Third, the IRS reduced the marital deduction by $2,330,951.34. The decrease in the marital deduction reflected the IRS's determination that the estate tax liability of $542,593.34 resulting from the inclusion of the gift tax paid within three years of death under Section 2035(b) that would have to be paid out of marital assets.

With respect to the first issue, the court noted that long standing precedent established that a claim against an estate is deductible in computing the estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise. The court noted that the key question to examine when there was a net gift as here in which the nieces had paid the gift tax owed, is whether a decedent's estate served as the ultimate source of the funds used to pay the liability that arose when the decedent parted with the value. In this case, decedent effectively provided the nieces with the wherewithal to pay tax on the taxable gifts because for each niece, a portion of the units transferred in 2002 was ultimately determined to a taxable gift. Decedent made the transfers to the nieces before he died, withdrawing from his potential estate not only the value of the taxable gifts but also the amount of the tax on the gifts. The court also noted that if decedent's estate paid the gift tax liability after decedent's death, it would have had a claim for reimbursement against the nieces to whom decedent had already provided the wherewithal for paying the tax. The court stated that inclusion of the gift tax in decedent's estate did not justify allowing deductions for gift tax in this case anymore than in a case of a gross gift for which the decedent paid the gift tax before the decedent died. As the court put it, "[o]ur acknowledgment that a net gift made within three years of the donor's death effects a removal of funds from the transfer tax base that must be redressed by the gross-up cannot be read as acquiescence in the permanent exemption from transfer tax that would result if the gross-up were offset by a deduction of the same amount under Section 2053(a)(3)."

The court also denied the estate's motion for partial summary judgment regarding the effect of the payment of debts and claims on the marital deduction because the amount of the allowable deduction turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay estate debts and expenses. Section 2056(a) allows a deduction for the "value of any interest in property which passes or has passed from the decedent to the surviving spouse". Treas. Reg. § 20.2056(b)-(4)(a) provides that value for that purpose means net value. Consequently, when property that would otherwise have been distributed to surviving spouse is used to satisfy debts of the estate, it is not included in the allowable marital deduction. The factual question of the extent to which assets otherwise exempt were used to pay debts and expenses precluded summary judgment since this was an issue of material fact and summary judgment may only be granted when there is no issue of genuine material fact.

The court then found that under the New Jersey's estate tax apportionment statute, no portion of any estate tax could be apportioned to the three nieces. Because the LLC units the three nieces received from their uncle were not included in computing the decedent's federal estate tax liability under the New Jersey apportionment statute, the nieces were not "transferees" against whom any of the estate tax liability could be apportioned for purposes of the New Jersey apportionment statute.

The court next looked at whether the payment of the estate tax would reduce the marital deduction claimed by the estate and held that the existing record did not allow for the determination of the effect of the payment of the estate tax on the allowable marital deduction. To the extent that the executor used the property that otherwise would have been exempt from claims against the estate to pay debts or expenses, the estate may have been a "transferee" subject to the apportionment of estate tax under the New Jersey apportionment rules. If neither the estate nor the nieces were "transferees" subject to the apportionment statute, the federal estate tax liability would be apportioned entirely to the estate. To the extent that any tax apportioned to the estate reduced the residuary distributions ultimately made to the wife's beneficiaries, the tax would be paid out of that marital share of the estate. The court did note that the New Jersey statute requires that total estate tax be apportioned in a manner that reserves for the benefit of decedent's spouse, to the extent possible, the benefit of any marital deduction. That statute provided insufficient grounds to rule that as a matter of law any estate tax due could not affect the allowable marital deduction.

15. Letter Rulings 201737001 and 201737008 (Issued June 14, 2017; Released September 15, 2017)

Reformation of power of appointment to make it a limited power of appointment is recognized

Grantor created an irrevocable trust to benefit spouse and descendants. The irrevocable trust contained a special power of appointment that provided that on the death of the spouse, the trustee is to distribute such amounts of principal and income as the spouse directed to such persons or charities as the spouse appointed by her will. The terms of the power of appointment did not specifically limit the exercise of the power to appoint to persons other than the spouse, the estate of the spouse, and the creditors of either. It was represented that the grantor intended for the power of appointment to be a limited power of appointment and not a taxable general power of appointment.

The grantor filed a petition with the local court to reform the trust to provide that the spouse would have a limited power of appointment and for the retroactive application of the reformation. The IRS ruled that because of the representations that the grantor did not intend for the spouse to have a general power of appointment and the representation of the lawyer who drafted the trust that an error had been made, the power of appointment as reformed by the local court would not constitute a general power of appointment and that the reformation of the trust was not the exercise or release of a general power of appointment that would constitute a gift by the spouse for federal gift tax purposes.

16. CCA 201745012 (Issued August 4, 2017; Released November 9, 2017)

Purchase of remainder interest in transferred property in which donor retained annuity, which purchase occurred on donor's deathbed during the term of the annuity, failed to replenish donor's taxable estate, and failed to constitute adequate and full consideration for gift tax purposes

Donor formed Trust 1, which was an irrevocable discretionary trust for the benefit of Donor's first spouse and issue. Trust 1 terminated on the later of the death of Donor or his first spouse, at which time the principal and any accumulated income were distributed outright to Donor's issue. Donor's first spouse predeceased him, and Donor then married second spouse. Later, Donor formed Trust 2, an irrevocable trust for the benefit of Donor and his issue. Under the terms of Trust 2, an annuity is payable to Donor for the term of the trust, and then the remainder is payable to his issue under the terms of Trust 1. Subsequently, Donor formed Trust 3, which had the same terms and provisions as Trust 2.

On what the Service described as Donor's "deathbed," Donor purchased the remainder interest in Trusts 2 and 3 from the trustees of Trust 1. Donor paid the purchase price with two unsecured promissory notes and died the following day.

Donor's estate reported the purchases of the remainder interest as non-gift transfers, asserting that Donor received adequate and full consideration in money or money's worth in the form of the remainder interest in Trusts 2 and 3.

The IRS ruled that where the purchase of the remainder occurs on Donor's deathbed during the term of the annuity, the remainder does not "replenish" the Donor's taxable estate. Consequently, the remainder does not constitute adequate and full consideration in money or money's worth for gift tax purposes pursuant to Merrill v. Fahs, 324 U.S. 308 (1945).

A companion Supreme Court case, Commissioner v. Wemyss, 324 U.S. 303 (1945), stands for the general proposition that "adequate and full consideration in money or money's worth" for gift tax purposes is that which replenishes or augments the donor's taxable estate. For example, B's relinquishment of marital rights in A's property will have no effect on the includable value of that property in A's gross estate. For that reason, the relinquishment of marital rights cannot replenish a donor's gross estate for estate tax purposes.

This memo noted that the relinquishment of marital rights did constitute valuable contractual consideration in the hands of Donor and did benefit Donor. This did not have the same effect for gift tax purposes. The Service noted that while Donor's liability on the promissory notes depleted

Donor's taxable estate, that does not matter for tax purposes. The purchase of the remainder interest in transferred property in which Donor has retained a Section 2036 "string" over the received remainder does not increase the value of Donor's taxable estate because the value of the entire property, including that of the remainder, is includable in Donor's gross estate.

The IRS also ruled that a note given in exchange for property does not constitute adequate and full consideration in money or money's worth for gift tax purposes is not deductible as a claim against the estate.

17. Badgley v. United States, _____ F.Supp.3d _____ (ND Cal 2018)

The assets of a GRAT are included in the settlor's estate

In 1998, Patricia Yoeder created a grantor retained annuity trust. Patricia was to receive annual annuity payments for the lesser of fifteen years or her prior death in the amount of 12.5 percent of the date of gift value of the property transferred to the GRAT. The GRAT paid Patricia an annuity of $302,259. Upon the end of the annuity term, the property was to pass to Patricia's two living daughters. The GRAT also stated that, if the trustor failed to survive the trust term, the trustee was to pay all the remaining annuity amounts and the portion of the trust included in the trustor's estate to the survivor's trust created under Patricia's revocable trust.

Patricia died on November 2, 2012 having received her last annuity payment from the GRAT on September 30, 2012.

The federal estate tax return reported a gross estate of $36,829,057, including the value of the assets held in the GRAT. The estate paid federal estate taxes of $11,187,457. On May 16, 2016 the estate filed a claim of refund seeking $3,810,004 in estate tax overpaid by the estate as a result of the inclusion of the full value of the GRAT. The case was before the court on cross-motions for summary judgment from the government and the estate.

The estate moved for summary judgment on two bases, asserting that Section 2036(a)(1) did not apply to Patricia's GRAT and that Treas. Reg. § 20.2036-1(c)(2) was overly broad and invalid to the extent that it applied to the GRAT and the transfer of property to the net of the bona fide sale for full and adequate consideration expenses to Section 2036. The government moved for summary judgment on the opposite grounds. The estate argued that a "fixed-term annuity" was not the same as a right to income or some other form of possession or enjoyment as required by Section 2036(a)(1). However, the government relied on three cases that took a broad approach to the operative language of Section 2036 and its predecessor: C. I. R. v. Church's Estate; 335 U.S. 632 (1939); Spiegel's Estate v. Commissioner, 335 U.S. 701 (1949); and Helvering v. Hallock, 309 U.S. 106 (1940). The court found that Section 2036 applied to the GRAT. Although plaintiff was correct that the government's authorities did not expressly equate a fixed-term annuity with a right to income or some other possession or enjoyment, the Supreme Court had adopted a substance over form approach that favored a finding that the annuity comprised some form of possession, enjoyment, or right to income from the transferred property.

Treas. Reg. 20.2036-1(c)(2)(i) requires that transferred GRAT property be included in a decedent's gross estate where the decedent retains an annuity interest and dies before the expiration of the annuity term. The court found that the regulation was valid even though Section 2036 does not equate “income” with a fixed term annuity in Section 2036. The silence did not mean that the interpretation of the Section is arbitrary or capricious. Instead the regulation is a permissible interpretation of Section 2036. The court also rejected the argument that the regulation was arbitrary because it would result in the inclusion of all private annuities in the decedent’s gross estate and was overly broad to the extent that the regulations subsequently included GRATs such as Patricia’s that “have no ordering rule, do not provide for income payments disguised as annuity payments, and at the time of grantor’s death can satisfy the annuity payments entirely out of principal.” The second argument failed once the court rejected the attempted distinction between an annuity and a right to income.

The court also rejected the argument that the creation of the GRAT was property transferred to the GRAT in a bona fide sale in exchange for an annuity. The court noted that the funding of the GRAT does not involve selling the transferred property to a third party in exchange for an annuity. There is no other owner of property engaging in the sale transaction other than the transferor.

Finally, the formula used to determine the included value of the GRAT was reasonable even though it assumed that the annuity was paid solely from income. The estate argued that an annuity can, in fact, be paid from either principal or income and thus the formula yielded a capriciously large amount to be included for tax.

As a result, Patricia’s GRAT was properly included in calculating the value of her gross estate.

VALUATION

18. Letter Ruling 201819010 (Issued February 8, 2018; Released May 11, 2018)

IRS grants extension of time to make Section 754 election

A general partnership was organized under state law. A and B owned a percentage interest in the partnership as community property. B died. The executor intended to make an election under Section 754 in connection with the death of B to step up the basis of partnership property. However, the executor failed to file a timely return to make the election. The executor represented that it had acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government.

Treas. Reg. § 1.754-1(b)(1) provides that an election under Section 754 to adjust the basis of partnership property is to be made in a written statement filed with a partnership return for the taxable year in which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed for filing the return for the taxable year. Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, a request for an extension of time to make an election will be granted when a taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that the grant of the relief will not prejudice the interests of the government. In this situation, the Service found that the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 were satisfied and granted an extension of time to make the Section 754 election

19. Letter Ruling 201743013 (Issued July 26, 2017; Released October 27, 2017)

Grandson's sale of interest in specially valued farm property to Daughter within 10 years of decedent's death will not cause an additional tax under Section 2032A

Upon Decedent's death, farm property passed to Daughter for life, and upon her death the remainder interest was to become the property of Daughter's two children. On Decedent's estate tax return, the executors elected special use valuation under Section 2032A. Grandson now proposed to sell his remainder interest in his one-half of the property to Daughter within the ten-year period after Decedent's death. The issue was whether Section 2032A(c) would apply. This Section provides that if within ten years after the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in the qualified use property (other than by a disposition to a member of the qualified heir's family), then an additional estate tax is imposed.

Section 2032A(e)(1) defines "qualified heir" as a member of decedent's family who acquired such property from the decedent. If the qualified heir disposes of any interest in qualified real property to any member of his family, such family member is treated thereafter as a qualified heir.

Section 2032A(e)(2) defines a member of the family as an ancestor of an individual, the spouse of such individual, a lineal descendant of such individual, such individual's spouse, the parent of such individual, or a spouse of any lineal descendent.

The IRS noted that in this situation, both Grandson and Daughter are qualified heirs of Decedent because they are lineal descendants of Decedent. Additionally, Daughter is a member of Grandson's family because Daughter is an ancestor of Grandson. Consequently, Grandson's sale of his remainder interest in the farm property to Daughter within ten years after Decedent's death will not be a disposition to a member of the family upon which an additional tax is imposed.

20. Letter Ruling 201814004 (Issued December 11, 2017; Released April 6, 2018)

IRS allows extension of time to make special use valuation election for farmland

Upon decedent's death, son and daughter were co-trustees of her revocable trust and co-executors of her estate which included farmland. Son and daughter retained an accountant to prepare and file the Form 706. The accountant failed to advise son and daughter to make the Section 2032A special use valuation election for the farmland. The son and daughter timely filed the Form 706.

After filing the Form 706, the son met with an attorney to discuss estate planning. The attorney discovered that the special use valuation election was never made on the Form 706. As a result of this discovery, the estate requested an extension of time to make the special use valuation election.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, an extension of time to make an election will be granted if the IRS determines that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional and the tax professional failed to advise the taxpayer to make the election.

The Service ruled that the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 had been satisfied and an extension of time to make the special use valuation election was granted.

21. Letter Ruling 201820010 (Issued February 13, 2018; Released May 18, 2018)

IRS allows extension of time for estate to elect alternate valuation date

The executor of decedent's estate consulted an attorney to prepare the Form 706. The Form 706 was timely filed however, the attorney failed to make the alternate valuation election under Section 2032 on the initial Form 706. The executor now requested an extension of time to make the alternate valuation election and use the alternate valuation method in reporting the value of the gross estate on the return.

Under Treas. Reg. §§ 301.9100-1(c) and 301.9100-3, the IRS may grant an extension of time if the taxpayer shows that the taxpayer acted reasonably and in good faith and that the granting of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election.

The IRS ruled that the requirements of regulations had been satisfied and granted an extension of time to make the alternate valuation election.

22. Letter Ruling 201815001 (Issued December 11, 2017; Released April 13, 2018)

IRS allows extension to elect alternate valuation date

Upon decedent's death, the executor of the estate consulted CPA to prepare the Form 706 which was timely filed. CPA failed to make the alternate valuation election under Section 2032 on the Form 706. The CPA stated in an affidavit that he intended to make the alternate valuation election, but failed to check the box. The executor requested an extension of time to make the alternate valuation method election.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, a reasonable extension of time may be granted if the taxpayer proves that the taxpayer acted reasonably and in good faith and the granting of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make the election.

The Service ruled that the requirements of the regulations had been satisfied and granted an extension of time to make the alternate valuation date election.

23. Letter Ruling 201825013 (Issued March 19, 2018; Released June 22, 2018)

IRS grants an extension of time to make the alternate valuation election

After decedent's death, the co-executors hired an attorney to prepare the estate tax return. The attorney prepared the estate tax return but failed to make the alternate valuation date election. The estate tax return was timely filed. Subsequently, after the due date of the estate tax return, the co-executors filed a supplemental estate tax return making the Section 2032 election. The Service then issued a letter to the estate stating that since the alternate valuation election was not made timely, the assets could only be valued using the alternate valuation date if an extension of time was granted under the relief provisions of Treas. Reg. §§ 301.9100-1 and 301-9100-3.

In this letter ruling, the IRS concluded that the standard of those treasury regulations were satisfied. Treas. Reg. § 301.9100-3 states that an extension of time for that relief will be granted if the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

24. Estate of Clara M. Morrissette v. Commissioner, ___ Tax Court Order (June 21, 2018)

Court denies partial summary judgment motion of estate that Section 2703 does not apply to split-dollar arrangement

Split-dollar is a method of financing the purchase of insurance. It most typically takes the form of an arrangement between a closely held business and an owner-employee, or between a public corporation and its executives, in which the employer and employee agree to split the payment of premiums on an insurance policy on the life of the insured. In 2001, the IRS announced its intent in Notice 2001-10, 2001-1 C.B. 459, to change its tax treatment of split-dollar arrangements. Thereafter, it issued new regulations, in final form, on September 17, 2003. The new taxation scheme created under these regulations significantly altered the way in which split-dollar arrangements were used for estate planning purposes thereafter.

Under the regulatory scheme put in place in 2003, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply, the economic benefit regime and the loan regime. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as compensation related agreement under the economic benefit regime. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61 of the Internal Revenue Code. The economic benefit rules apply to both arrangements where the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to arrangements in which the employee owns the policy (collateral assignment split-dollar arrangements) but the employee's only right is to the insurance protection. In this latter situation, the employer will be deemed to own the policy. Treas. Reg. § 1.61-2(c)(1)(ii)(A)(2).

Any split-dollar arrangement not described above in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. Here, transfers by the employer will be treated as loans and there will be deemed interest to the extent that the arrangement does not mandate adequate interest. The deemed interest will treated as compensation paid by the employer to the employee and then repaid as interest by the employee. The same rules will apply to split-dollar arrangements in all other contexts, such as shareholder-company and private donor-donee arrangements.

Morrissette involved a motion for partial summary judgment in a private donor-donee arrangement. The unique feature here is that the insureds were much younger than the donor. In Morrissette, Clara Morrisette established a revocable trust in 1994 to which she contributed all of her shares in Interstate Group Holdings which, in turn, held eleven moving and other companies. In September 2006, when Clara Morrissette was 93, her three sons became trustees of the revocable trust. Previously, on August 18, 2006, an employee of Interstate Group Holdings was appointed as a temporary conservator of Clara's Morrisette's estate through October 20, 2006. The conservator transferred additional assets into the revocable trust. In addition, the conservator established three perpetual dynasty trusts in 2006, one for each of her three sons and his family. The revocable trust was amended on September 19, 2006 to permit the trustees to pay premiums on life insurance and to make loans and to enter into split-dollar arrangements.

Next, on September 21, 2006, the dynasty trusts, the three brothers, the revocable trust, and other trusts holding interests in Interstate Group Holdings entered into a shareholders agreement providing that upon the death of each brother, the surviving brothers, and the dynasty trusts would purchase the Interstate Group Holdings stock held by or for the benefit of the deceased brother. To provide each dynasty trust with the funds to purchase the Interstate Group Holdings stock held by a deceased sibling, each dynasty trust on October 4, 2006 purchased a universal life policy on the life of each of the two other brothers.

Clara Morrissette's revocable trust on October 31, 2006 entered into two split-dollar life insurance arrangements with the three dynasty trusts and then contributed $29.9 million in total to the three dynasty trusts in order to fund the purchase of the universal life insurance policies on each of Clara Morrissette's three sons. The split-dollar life insurance arrangements provided that the revocable trust would receive the greater of the cash surrender value of the respective policy or the aggregate premium payments on that policy upon termination of the split-dollar life insurance arrangement or the death of the insured brother. The right to receive a portion of the death benefit would thus be a receivable of the revocable trust.

Each split-dollar agreement provided that the agreement would be taxed under the economic benefit regime and that the only economic benefit provided to each dynasty trust was the current life insurance protection. The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure the payment of the amounts owed to the revocable trust. Neither the dynasty trusts nor the revocable trust retained the right to borrow against the policies.

In each of 2006 through 2009, Clara Morrissette reported gifts to the dynasty trusts under the economic benefit regime of the cost of the current life insurance protection determined under Table 2001 less the amount of the premiums paid by the dynasty trusts. Clara Morrissette died on September 25, 2009 and was survived by her three sons. After Mrs. Morrissette's death, the estate retained Valuation Services, Inc. to value the receivables included in the gross estate as of the date of her death. Valuation Services, Inc. valued the receivables at $7,479,000.

The IRS in the audit of Clara Morrissette's estate determined that the $29.9 million contribution was a gift in 2006 and assessed a gift tax deficiency against Clara Morrissette's estate of $13,800,179 and a penalty of $2,760,036. The estate moved for partial summary judgment on the narrow issue of whether the split-dollar insurance arrangements were governed by the economic benefit regime under Treas. Reg. § 1.61-22.

The court first noted that the 2003 final regulations governed the split-dollar arrangements since they were entered into after September 17, 2003. The court also noted that generally the person named is the owner in the insurance contract is treated as the owner of the contract. Under this general rule, the dynasty trusts would be considered the owners of the policies and the loan regime would apply. However, the final regulations included the special ownership rule that provided that, if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is the current life insurance protection, then the donor will be deemed the owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply.

To the court, the key question was whether the lump sum payment of premiums made directly made by the revocable trust on the policies in 2006 generated any additional economic benefit other than the life insurance protection to the dynasty trusts. If there was no additional economic benefit to the dynasty trusts, then the revocable trust would be deemed the owner of the policies by way of the special ownership rule and the split-dollar life insurance arrangements would be governed by the economic benefit regime. To determine whether any additional economic benefit was conferred, the relevant inquiry was whether the dynasty trusts had current access to the cash values of the respective policies under the split-dollar life insurance arrangement or whether any other economic benefit was provided. The court determined that the dynasty trusts did not have access to any part of the cash value of the insurance policies or to any other economic benefit except for the current life insurance protection. As a result, the economic benefit regime and not the loan regime applied.

The important issue yet to be determined with respect to Morrissette is the value of the receivables in Clara Morrissette's estate for estate tax purposes and whether the receivables should only be valued at approximately $7,500,000. The resolution of this issue will determine the usefulness for estate and gift tax purposes of the split-dollar financing of the policies in this particular situation.

On December 5, 2016, the estate moved for partial summary judgment that Section 2703 does not apply for purposes of the valuation of Clara Morrissette property rights under the split-dollar arrangements estate tax. Section 2703(a) provides that for transfer tax purposes with respect to buy-sell and similar arrangements between family members, the value of properties are determined without regard to (1) any option, agreement, or other right to acquire or use property at less than fair market value, or (2) any restriction on the right to sell or use the property.

As noted above, the decedent entered into split-dollar arrangements through her revocable trust with the three dynasty trusts that had been established in the name of each of her three sons. The court held that the economic benefit regime applied and the cost of the current insurance protection was a transfer each year from the decedent to the son for gift tax purposes. The parties agreed that for estate tax purposes the estate must include the decedent's rights under the split dollar arrangements in the gross estate. The parties disagreed over exactly what rights the decedent had over the split-dollar arrangements and whether those rights were subject to any restrictions pursuant to Section 2703(a)(2). The estate argued that the decedent's only right under the split-dollar arrangement was the death benefit and that right was without restriction. The government argued that the decedent's right also included the right to terminate the split-dollar agreements with the consent of the other party at any time and to receive a payout upon termination. It argued that the termination rights were restricted by the split-dollar arrangements and that Section 2703(a)(2) applied to disregard the termination restrictions. The IRS also argued that decedent had rights under the collateral assignment agreements and that those restrictions should be disregarded. As a result, summary judgment should be denied because there was a genuine issue of material fact.

Pursuant to Estate of Cahill v. Commissioner, T.C. Memo 2018-84, a restriction on a decedent's termination rights is a restriction for purposes of Section 2703. In Estate of Cahill, the Tax Court denied the estate's motion for partial summary judgment that Section 2703(a) did not apply to split-dollar arrangements with termination restrictions similar to those at issue in Morrissette where the parties to the agreements can mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. Here the decedent's trust and the respective dynasty trusts could mutually agree to terminate the split-dollar arrangement but neither party could unilaterally terminate the agreement.

As a result, the motion for partial summary judgment was denied.

25. Cahill v. Commissioner, T.C. Memo 2018-84

Taxpayer's motion for summary judgment with respect to split-dollar arrangement is denied

Richard F. Cahill died on December 12, 2011. His son, Patrick Cahill, was named as executor. This case involves three split-dollar agreements that were executed in 2010 when Richard was 90 years old and unable to manage his own affairs.

Richard was the settlor of a revocable trust called the Survivor Trust. Patrick was the trustee of the Survivor Trust and was also decedent's attorney-in-fact under a California Power of Attorney. Richard's involvement in the three split dollar life insurance arrangements was effected solely through the Survivor Trust and was directed by Patrick Cahill either as decedent's attorney in fact or as trustee of Survivor Trust. The parties agreed that everything in the Survivor Trust on decedent's date of death was included in the decedent's gross estate. Decedent was also settlor of the Morrison Brown ("MB") Trust which was created in September 2010 by Patrick Cahill as decedent's agent. William Cahill was trustee of the MB Trust and the primary beneficiaries of the MB Trust were Patrick and his issue. The MB Trust owned three whole life insurance policies. Two policies were on the life of Shannon Cahill, Patrick Cahill's wife, and one policy was on the life of Patrick Cahill. The policy premiums were paid in lump sums as shown in the chart below.

	Policy Premium	**Policy Amount**
New York Life on Patrick Cahill	$5,580,000	$40,000,000
SunLife on Shannon Cahill	$2,531,570	$25,000,000
New York Life on Shannon Cahill	$1,888,430	$14,800,000
TOTAL	**$10,000,000**	**$79,800,000**

To fund these policies, three separate split-dollar agreements were executed by Patrick Cahill, as the trustee of the Survivor Trust, and William Cahill as trustee of the MB Trust. The Survivor Trust paid the premiums using funds from a $10 million loan from Northern Trust. The obligors on the loan were the decedent personally and Patrick Cahill as trustee of the Survivor Trust. Each split dollar arrangement was designed to take advantage of the economic benefit regime and avoid the loan regime. Upon the death of the insured, the Survivor Trust was to receive a portion of the death benefit equal to the greatest of the remaining balance on the loan, the total premiums paid with respect to the policy, or the cash surrender value. The MB Trust would retain any excess.

Each split-dollar agreement also provided that it could be terminated during the insured’s life by written agreement between the trustees of the Survivor Trust and the MB Trust. As of the date of Richard’s date in 2011, the aggregate cash surrender value of the policies was $9,611,624. The estate’s tax return reported the total value of decedent’s interest in the split-dollar agreements at $183,700. In the Notice of Deficiency, the IRS adjusted the total value of decedent’s rights in the split-dollar arrangements from $183,700 to $9,611,624, the cash surrender value of the policies.

The estate moved for partial summary judgment. A court may grant summary judgment when there is no genuine dispute as to any material facts and a decision may be granted as a matter of law. The court first found that Section 2036 and Section 2038 would apply in this situation. The estate tried to argue that neither Section applied because the decedent retained no rights with respect to the amounts transferred to justify application of those Sections. However, the court noted that the decedent retained the right to terminate and recover at least the cash surrender value held in conjunction with the MB Trust and that those constituted rights under Section 2036 and Section 2038. The court then noted that with respect to the requirements in Sections 2036 and 2038, questions remained as to whether decedent’s transfer of $10 million was part of a bona fide sale. It also noted that the issue of whether the transfer was for full and adequate consideration was a question of fact. It stated that the bona fide sale for adequate and full consideration exception was not satisfied because the value of what the decedent received was not even close to the value of what decedent paid.

The court also reviewed the argument of the government that Section 2703 would apply to the MB Trust’s ability to veto termination of split-dollar arrangements. It found that split dollar agreements, taken as a whole, clearly restricted decedent’s right to terminate the agreements and withdraw his investment from those arrangements. The court stated that the requirements of Sections 2703 were met and therefore denied the motion for summary judgment with respect to this. The court also noted that the parties had not addressed the exception in Section 2703(d) which provides for comparison with the terms of any similar arrangements entered into by persons in arms’ length transactions.

The court also rejected the estate’s contention that any part of the difference between the $183,700 that decedent allegedly received in return and the $10 million decedent paid would be accounted for as gifts and that to count the difference as part of the estate under Sections 2036, 2038 and 2703 would be double counting.

The estate also sought summary judgment that pursuant to Treas. Reg. § 1.61-22, the economic benefit regime would apply to split dollar arrangements. The IRS countered that the regulation did not apply for estate tax purposes and stated that the economic benefit regime rules only are gift tax rules. The court noted that to the extent that the regulations eliminated the gift tax treatment and that those transfers are relevant to the estate tax issues it would look at the regulations in deciding the case. The estate also argued that the court should modify the approach required by Sections 2036, 2038 and 2703 to avoid inconsistency between the statutes and the regulations. The court disagreed. First, it found no inconsistency between the estate tax statutes and the income tax regulations. It also disagreed with the estate's argument, which was confusing to the court, that because Treas. Reg. § 1.61-22 did not deem the difference to be a gift, then the entire $10 million transferred must have been for full and adequate consideration. As a result, the estate's motion for partial summary judgment was denied. The government did not move for summary judgment on any of the issues discussed.

CHARITABLE GIFTS

26. RERI Holdings LLC v Commissioner, 149 T.C. No. 1 (July 3, 2017)

Tax Court denies income tax charitable donation for gift of LLC interest

RERI Holdings I, LLC ("RERI") donated an LLC interest that was subject to a prior estate for years through 2020 to the University of Michigan in August 2003. RERI had purchased the LLC interest in March 2002 for $2,950,000. However, on its 2003 partnership return, RERI claimed an income tax charitable contribution deduction of $33,019,000 for the transfer to University of Michigan. The income tax return for RERI contained a Form 8283 Appraisal Summary which disclosed the March 2002 purchase, but left blank the place for "donor's cost or other adjusted basis". Two years after receiving the gift, the University of Michigan sold the LLC interest for $1,940,000 to another LLC indirectly owned by RERI.

The IRS disallowed RERI's deduction entirely on the grounds that the transaction was a sham for income tax purposes or lacked any economic substance. RERI moved for summary judgment in the Tax Court on the grounds that neither the sham transaction doctrine nor the lack of economic substance doctrine applied to the charitable gift. The Tax Court held that both the sham transaction doctrine and the lack of economic substance doctrine applied and denied summary judgment to RERI.

The IRS then moved for partial summary judgment that the actuarial tables under Section 7520 could not be used to value the future interest that RERI contributed to the University of Michigan and that RERI had failed to substantiate the value of its contribution with a qualified appraisal. The court denied summary judgment to the IRS on its motion for partial summary judgment.

The court at trial noted that the omission of basis from the Form 8283 violated the substantiation rules because the cost basis would have alerted the IRS to a potential overvaluation of the charitable gift. As a result, the omission cannot be excused on grounds of substantial compliance. The court then noted and found that the actuarial factors under Section 7520 did not apply. It also found that the fair market value of the property contributed to the University of Michigan on the date of the contribution was $3,462,886 and that the gross valuation misstatement penalty would apply.

27. 310 Retail, LLC v. Commissioner, T.C. Memo 2017-164

Deed of easement constitutes contemporaneous written acknowledge for charitable income tax deduction for gift of conservation easement

This case was before the Tax Court on cross motions for partially summary judgement as to whether a contemporaneous written acknowledgement for a charitable gift was provided. The court noted that the Form 8283 filed by 310 Retail, LLC when the gift was made did not meet the requirements of a contemporaneous written acknowledgement because it failed to include any information on whether the Landmark Preservation Council to which conservation easement was deeded had supplied 310 Retail, LLC with any goods or services. The July 2009 letter contained that information but it was not contemporaneous.

310 Retail, LLC had filed an amended Form 990 for the tax year that disclosed the façade easement and stated that no goods or services provided exchanged therefore. However, the court held that the Form 990 did not meet the requirements for contemporaneous written acknowledgment since the regulations as in force did not provide for an alternative method to a contemporaneous written acknowledgment.

However, the court found that a deed of easement may qualify as a contemporaneous written acknowledgement if it contains the required information. The court noted that in Averyt v. Commissioner, T.C. Memo 2012-198, the granting provisions stated the donor conveyed a perpetual conservation easement in consideration with the mutual covenants, its terms, conditions and restrictions set forth and as an absolutely unconditional gifts subject to all manners of record. It also stated that this instrument sets forth the entire agreement of the parties with respect to the easement and supersedes all prior discussions, negotiations, and understanding of the agreements relating to the easement all which are merged herein. That deed qualified as a contemporaneous written acknowledgement. As a result, the merger clause, read in connection with the other statements deed of easement, supplied the affirmation that is required for a contemporaneous written acknowledgement that no goods or services were received in exchange for the contribution. The reasoning in Averyt was followed in RP Golf, LLC, T.C. Memo 2012-282.

The court found that the deed of easement in this case was similar in all materials respects to the deed in RP Golf, LLC and stated that the deed would qualify as contemporaneous written acknowledgement.

28. Big River Development, LP v. Commissioner, T.C. Memo 2017-166

Deed of easement constitutes contemporaneous written acknowledge of charitable gift

This case involves a charitable contribution deduction claimed by Big River Development, LP for a conservation easement. The court had previously held that deed of easement may constitute a contemporaneous written acknowledgment in 310 Retail, LLC v. Commissioner, T.C. Memo

2017-164; RP Golf, LLC v. Commissioner, T.C. Memo 2012-282; and Averyt v. Commissioner, T.C. Memo 2012-198.

In this case, Big River acquired a property in Pittsburgh, Pennsylvania and began converting the building into a luxury apartment complex. On January 12, 2005, Big River executed a deed of historic preservation conservation easement to the Pittsburgh History and Landmarks Foundation over the façade of the building. The deed of easement noted that Big River was granting to the Pittsburgh History and Landmarks Foundation the façade easement pursuant to Section 170(h) of the code. The deed recited the obligations and would be deemed to run as a binding servitude with the property in perpetuity. It noted that the foundation would monitor Big River's compliance with the easement restrictions. It also noted that Big River was paying the foundation a fee of $93,500 to endow the monitoring of the easement.

Big River secured an appraisal that valued the façade easement at $7.14 million and claimed a $7.14 million charitable contribution deduction on its income tax return. While Big River attached a Form 8283 executed by the appraiser and by the foundation's president, this document contained no statement as to whether the foundation had provided any goods or services to Big River in exchange for its gift. Two years after the gift was made, the foundation supplied Big River with a letter stating that the foundation had not provided any goods or services in exchange for the contribution.

In 2009, the IRS proposed to disallow the charitable contribution deduction because there was no contemporaneous written acknowledgement. In this summary judgment proceeding, the court noted that the requirement of a contemporaneous written acknowledge is a strict one when there is a gift of $250 or more. The Form 8283, while contemporaneous, did not include the statement as to whether the Foundation had provided any goods or services in exchange for the gift. The letter provided by the foundation in 2007 included that statement that it was not contemporaneous. The court however then found that Big River received a contemporaneous written acknowledgement in the form of the deed of easement. It noted that the deed of easement was property executed by the foundation's president contemporaneously with the gift. To the extent that the foundation's monitoring activities constituted the rendering of services to Big River, the deed of easement provided a description and a good faith estimate of the value of those services. Finally, because the deed of easement explicitly stated that it represented the parties' entire agreement, it negated the receipt by Big River of any other goods or services from the foundation. As a result, the deed of easement constituted a contemporaneous written acknowledgement meeting the requirements of Section 170(f)(8)(B).

29. Ohde v Commissioner, T.C. Memo, 2017-137

Husband and Wife denied income tax charitable contribution deduction for over 20,000 items donated to Goodwill Industries in 2011

Mark and Rose Ohde claimed an income tax charitable deduction of $145,250 for over 20,000 items donated to Goodwill Industries in 2011. This included 3,454 items of clothing, 115 chairs, 36 lamps, 22 bookshelves, 20 desks, 20 chest of drawers, 16 bed frames, 14 filing cabinets, and 3,153 books. For each delivery, Goodwill gave them a one-page, generic receipt stating no quantities or values.

For 2007 through 2010, the Ohdes had claimed income tax charitable deductions for non-cash charitable contributions aggregating $292,143. For 2012 and 2013, the Ohdes claimed income tax charitable deductions for non-cash charitable contributions aggregating $104,970. The Tax Court found none of the taxpayers' testimony creditable, disallowed the entire deduction, and sustained an accuracy-related penalty.

Ron Aucutt has offered the following reflection on the Ohde case:

Mark and Rose Ohde
Drove down the road,
And with a load
Goodwill bestowed.

But what they sowed
Would soon implode,
And, per the Code,
Big bucks they owed.

30. Roth v. Commissioner, T.C. Memo 2017-248

Couple liable for penalties for overstating value of easement donation

Husband and Wife donated a conservation easement encumbering 40 acres of land in Prowers County, Colorado. On their 2007 federal income tax return, the petitioners valued the conservation easement at $970,000 and claimed a charitable contribution deduction based on that amount. The petitioners had to carry over part of the deduction to 2008 because of the percentage limitations for the income tax charitable deduction.

The IRS disallowed the deductions and determined income tax deficiencies for 2007 and 2008, respectively. The IRS also determined 20% accuracy related penalties under Section 6662(a) for the two tax years. In its answer to the taxpayer's petition, the IRS affirmatively asserted 40% gross valuation penalties of Section 6662(h) for those tax years. The IRS examiner determined that the conservation easement was improperly valued and that the correct value was zero. The examiner also determined that Husband and Wife were liable for a 40% penalty under Section 6662(h). The examiner determined that in the alternative, Husband and Wife were liable for a 20% accuracy related penalty under Section 6662(a). The parties reached a settlement under which they agreed that Husband and Wife were entitled to a charitable contribution deduction of $30,000 for 2007. The parties also agreed that Husband and Wife had reasonable cause for the value of the charitable contribution. Accordingly, the IRS conceded that Husband and Wife were not liable for the 20% accuracy related penalty under Section 662(a).

The difference in the agreed value of $30,000 and the claimed value of $970,000 also met the test for a gross valuation in statement as defined in Section 6662(h). Unlike the 20% accuracy related penalty, Husband and Wife could not claim reasonable cause to avoid liability for the 40% gross valuation misstatement penalty. However, the petitioners assert that the imposition of the 40% penalty was inappropriate because the IRS failed to comply with procedural requirements to impose the 40% penalty.

In addition, as a result of a claimed donation of an earlier separate conservation easement in 2006, Husband and Wife received Colorado state income tax credits. During 2007, Husband and Wife sold a portion of those credits to another Colorado state taxpayer for $195,000. As a result of litigation in Colorado state court, Husband and Wife repaid $24,662 of that sum in 2013 and a further $83,489 in 2014. Husband and Wife asserted that they were entitled to a deduction for tax year 2007 for the amounts of the repayments in tax years 2013 and 2014.

Husband and Wife alleged the IRS failed to comply with Section 6751(b) which provides that no penalty shall be assessed unless the initial determination of such assessment is personally approved by the immediate supervisor of the individual making such determination or such higher level official as may be designated by the secretary. Husband and Wife asserted that the initial determination referenced by Section 6751(b)(1) is the issuance of the notice of deficiency. While written approval for the gross valuation misstatement penalty was obtained before the issuance of the notice of deficiency, Husband and Wife contended that it was the appeals office that handled their case and not the examiner who made the initial determination with respect to the gross valuation misstatement penalty, and because the appeals officer failed to get approval from his immediate superior, the IRS failed to comply with the requirements and could not assess the penalty against them.

The court noted that the resolution of the disputes was controlled by its decision in Graev and Chai v. Commissioner, 851 F.3d 190 (2d Cir. 2017). It noted that in all three of the instances in which the IRS sought to assert penalties in this case, the individual proposing the penalties received the personal approval of his or her immediate supervisor. The examiner who proposed the 40% gross valuation misstatement penalty the first time (and the 20% accuracy related penalty in the alternative) received personal written approval from her group manager. Likewise, the appeals office received personal written approval from the team manager for the 40% gross valuation misstatement penalty and for the 20% penalty that was shown on the notice of deficiency. The senior counsel who pleaded affirmatively in the IRS answers that Husband and Wife were liable for the 40% gross valuation misstatement penalty received the associate area counsel's personal written approval. As a result, no matter which of the three instances was the initial determination of the 40% penalty, the requirements of Section 6751(b) were satisfied. As a result, the petitioners were liable for the 40% gross valuation misstatement penalty.

The court also determined that Husband and Wife were not entitled to deduct in 2007 the repayments of state tax credits that were made in 2013 and 2014. Section 1341(a) has three requirements. The first is that the item must have been included in gross income for a prior taxable year or years because it appeared that taxpayer had the unrestricted right to it. The second is that the deduction is allowable for the taxable year at issue because it was established after the close of such prior taxable year or years that the taxpayer did not have an unrestricted right to it. The third is that the amount of such deduction exceeds $3,000. These requirements were not met for the year 2007.

31. Wendell Falls Development, LLC v. Commissioner, T.C. Memo 2018-45

No charitable contribution deduction is allowed for the donation of a conservation easement and no penalty is applicable

The IRS disallowed an income tax charitable contribution deduction of $1,798,000 for the contribution of a conservation easement by Wendell Falls LLC. The IRS also sought to impose a 40 percent penalty for a gross valuation misstatement or, in the alternative, a 20 percent penalty for a substantial valuation misstatement. Wendell Falls, as part of a planned unit development in Wake County, North Carolina, intended to develop 1,280 acres. It also identified 125 acres of the 1,280 acres as the land upon which a park would be placed. In late 2006, the Wake County Board of Commissioners authorized the county to buy the 125 acres identified on the map as a park. Because of an incorrect reference in the planned unit development to the park having 160 acres as opposed to 125 acres, the purchase agreement inadvertently stated that the acreage of the planned park was 160 acres. The purchase agreement also stated that placing a mutually agreeable conservation easement on the land was a precondition to the sale. After realizing the mistake and having a new appraisal done, the land was valued at $3,020,000 unrestricted by any conservation easement and the Wake County Board of Commissioners reauthorized the purchase. On June 7, 2007, a conversation easement on the 125 acres was placed on the property and subsequently a general warranty deed was recorded transferring ownership of the 125 acres from Wendell Falls to Wake County.

On its partnership return for 2007, Wendell Falls claimed a charitable contribution deduction of $1,798,000 for the contribution of the conservation easement. The value of the conservation easement, according to the appraiser, was $4,818,000, and $1,798,000 represented the difference between the appraised value and the price paid by Wake County. The court denied the charitable contribution deduction for the easement for two reasons. The first was that Wendell Falls expected a substantial benefit from the conservation easement. The evidence showed that Wendell Falls would benefit from the increased value in the lots to be sold in the planned unit development from having the park as an amenity. Consequently, Wendell Falls donated the easement with the expectation of receiving a substantial benefit. The court held that the charitable contribution deduction was not allowable because of the expectation of the substantial benefit.

Alternatively, the value of the easement was zero. An easement must have value to generate a charitable contribution deduction. In order to determine the value because there were no sales of easements comparable to the easement contributed by Wendell Falls, the value of the easement would be equal to the value of the land before the easement minus the value of the land after the easement. In looking at the plan developed by Wendell Falls which had owned the entire 1,280 acres including the 125 acres, the best use of the 125 acres was as a park in the midst of a master planned community. The conservation easement did not diminish the value of the 125 acres because it was not prevented from being put to its best use. As a result, the value of the easement was zero.

After trial, the IRS conceded that the 40 percent penalty for gross valuation misstatement did not apply. The court rejected the imposition of the 20 percent penalty because Wendell Falls LLC had acted in good faith since it had hired two different state-certified real estate appraiser to value the conservation easement.

32. Notice 2017-73, 2017-51 IRB 562 (December 4, 2017)

IRS describes approaches being considered to address certain issues regarding Donor Advised Funds

This notice describes approaches that the Treasury Department and the Internal Revenue Service are considering to address certain issues regarding Donor Advised Funds. Specifically, the Treasury Department and the IRS are considering developing proposed regulations that would provide that certain distributions from a Donor Advised Fund that paid for the purchase of tickets that enable a Donor, Donor advisor, or related person to attend or participate in a charity-sponsored event do not result in more than an incidental benefit to such person. The Treasury Department and the IRS are also considering proposed regulations that distributions from a Donor Advised Fund that the distributee charity treats as fulfilling a pledge made by a donor, a donor advisor, or related person do not result in more than an incidental benefit if certain requirements are met. The Treasury Department and the IRS are also considering developing proposed regulations that would change the public support computation for organizations to prevent the use of Donor Advised Funds to circumvent the excise taxes applicable to private foundations. The notice requests comments regarding the issues addressed.

If regulations are issued as described in this notice, a beneficial development is that a Donor Advised Fund will be able to pay pledges, whether legally binding or not, made by the Donor of the Donor Advised Fund. Previously, the implications of satisfying a pledge with a grant from a Donor Advised Fund were unknown. One commentator has described the proposed IRS policy as "don't ask, don't tell."

GENERATION-SKIPPING TRANSFER TAX

33. Letter Ruling 201750014 (Issued September 12, 2017; Released December 15, 2017)

Extension of time granted to sever a marital trust into exempt and non-exempt trust and to make a reverse QTIP election

Decedent's will provided for the creation of a bypass trust and a marital trust at his death. The marital trust qualified for QTIP treatment. Upon Decedent's death, the personal representative retained an accountant to prepare the Form 706. On Schedule M of the Form 706, the personal representative made the QTIP election with respect to the marital trust. However, the accountant failed to advise the personal representative to divide the marital trust into exempt and non-exempt marital trusts and to make a reverse QTIP election in order to allocate Decedent's remaining GST exemption to the exempt marital trust.

The personal representative's error was discovered when the surviving spouse hired a second attorney to plan her estate. Consequently, an extension of time was requested to sever the marital trust into a GST exempt marital trust and a non-exempt marital trust and to make a reverse QTIP election to allocate Decedent's remaining GST exemption to the exempt marital trust.

The IRS granted the request for an extension of time. Under Treas. Reg. § 301.9100-3, an extension of time will be granted when the taxpayer can establish that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional to make an election. The requirements for this regulation were satisfied in this case. Decedent's estate was granted an extension of time to sever the marital trust into exempt and non-exempt marital trusts and to make a reverse QTIP election with respect to the exempt marital trust. In addition, the automatic allocation rules of Section 2632(e) would apply to automatically allocate the unused GST exemption to the exempt marital trust.

34. Letter Rulings 201820007 and 201820008 (Issued February 5, 2018; Released May 18, 2018)

Proposed distribution from one generation-skipping tax exempt trust to another exempt trust will not cause either trust to lose their exempt status

These letter rulings concern irrevocable GST exempt trusts created after September 25, 1985. Separate trusts were established with identical terms for the benefit of the Settlor's two sons. Trust A was an irrevocable trust for the benefit of one son and Trust B was an irrevocable trust for the benefit of a second son.

The trustee could currently distribute income and principal to each son for the son's support, maintenance, education, and health. Upon the death of the son, the son had a limited testamentary power of appointment to the issue of the Settlor. Otherwise the property passed per stirpes to the son's then living issue.

Trustee subsequently appointed all the principal and accumulated income of one of the trusts to a new trust, known as Trust C. During the son's lifetime, the distribution standard and trustee were the same as the distribution standard and trustee in Trust A. The son continued to have a testamentary limited power of appointment to the settlor's issue. However, Trust C expressly provided that the son could create a new trust for the benefit of permissible appointees. The beneficiary of each new trust was given a testamentary general power of appointment which would cause the assets of the trust to be included in the estate of the beneficiary at his or her death. Consequently, the distribution of property from Trust A to Trust C would not cause a shift to beneficial interest to lower generation or extend the time for vesting of any beneficial interest.

As a result, the proposed appointment from Trust A to Trust C would not cause the trust to lose its exempt status for GST purposes because the new trust satisfied the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(D) since the change would not shift any beneficial interest to a lower generation and would not extend the term of the trust beyond the period permitted in the original trust.

35. Letter Ruling 201815012 (Issued November 14, 2017; Released April 13, 2018)

Extension of time granted to allocate spouse's available GST exemption

Decedent while alive established an irrevocable trust for the benefit of decedent's children and their descendants. Decedent died survived by spouse and children. An accountant prepared the gift tax returns for the transfer to the trust and decedent's spouse elected to split gifts on the gift tax return. However, the CPA failed to allocate any GST exemption to the initial transfer to the trust. The error was discovered later when an attorney discovered that no GST exemption had been allocated to the transfer of the trust on the gift tax return. The spouse had sufficient GST exemption that year to completely exempt the trust from GST Tax and requested an extension of time to do so.

The Service ruled that under Section 2642(g)(1)(A) and Treas. Regs. §§ 301.9100-1 and 301.9100-3, an extension of time should be granted. The two regulations provide that an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make the election.

36. Letter Ruling 201747002 (Issued August 9, 2017; Released November 24, 2017)

Executor granted extension of time to allocate decedent's GST exemption to family trust

When Decedent died, Decedent's will created both a family trust and a marital trust. The family trust received a certain dollar amount of assets and had GST tax potential. An accounting firm prepared and filed the Form 706. On the Form 706, the accounting firm allocated X dollar amount of Decedent's GST exemption to the "family QTIP trust." As a result, the accounting firm failed to properly allocate the dollar amount of Decedent's available GST exemption to the family trust.

Decedent's estate requested an extension of time to allocate Decedent's available GST exemption to the family trust. Treas. Reg. § 301.9100-3 provides that an extension of time will be granted when a taxpayer shows that the taxpayer acted reasonably and in good faith and that granting a relief will not prejudice the interests of the government. The regulation also provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. These requirements were met in this letter ruling and the IRS granted an extension of time to allocate Decedent's GST exemption to the family trust.

37. Letter Ruling 201801001 (Issued September 20, 2017; Released January 5, 2018)

Estate granted an extension of time to allocate GST exemption

When Decedent died, the residue of his estate passed to Trust 1. Trust 1, in turn, created an irrevocable sub-trust, Trust 2, for the benefit of Decedent's spouse and issue. An attorney prepared the Form 706; however, the attorney failed to allocate GST exemption to Trust 2.

The error was discovered subsequently when the surviving spouse and a son consulted a second attorney regarding the family estate planning and discovered that the GST exemption had not been allocated to Trust 2 on the Form 706. They then requested an extension of time to allocate GST exemption to Trust 2. Under Treas. Reg. § 301.9100-3, an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. The regulation provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The Service found that the requirements of Treas. Reg. § 9100-3 had been met and the request for an extension of time to allocate GST exemption was granted.

38. Letter Rulings 201803001 and 201803002 (Issued September 18, 2017; Released January 19, 2018)

Extension of time to allocate GST exemption granted

In these companion letter rulings, Donor established an irrevocable trust for the benefit of his child. Although the trust had GST potential, a portion of the trust had the potential to be included in the gross estate of a non-skip person other than the transferor if such person died immediately after the transfer. Donor retained an accountant and an attorney for advice on reporting the transfers and preparing the necessary Form 709. At all times, Donor indicated his intention that the trust be exempt from GST tax.

Accountant prepared a Form 709, on which Donor reported his transfers to the trust. However, in preparing the Form 709, his accountant failed to allocate GST exemption to the transfer to the trust. No Forms 709 were prepared for the thirteen subsequent years in which Donor made transfers to the trust based on the accountant's and attorney's advice that filing Forms 709 was unnecessary. At the time the error was discovered, Donor had sufficient GST exemption to allocate to the transfers. Donor requested an extension of time to allocate GST exemption to the transfers to the trust in years 1 through 3 and to treat the trust as a GST trust with respect to all transfers made by Donor to the trust.

Treas. Reg. § 301.9100-3 provides that an extension of time to make an election may be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The IRS found that the requirements of the regulation had been satisfied and granted an extension of time to allocate GST exemption to the gifts made in the first three years. In addition, Donor was granted an extension of time to treat the trust as a GST trust with respect to the transfers to the trusts in the fourth year and all subsequent transfers. That would cause the automatic allocation of Donor's unused GST exemption to the trust in those years.

39. Letter Rulings 201811002 and 201811003 (Issued November 27, 2017; Released March 16, 2018)

Service rules on application of split-gift rules to the allocation of GST exemption

These two rulings dealt with the same transaction. Husband created four irrevocable trusts, one for each of his four children of which each child was the primary beneficiary. Upon each child's death, the principal was to be held in further trust and distributed outright to the child's children upon those children obtaining age 35. An accounting firm prepared the gift tax returns for husband and wife. Husband and wife consented to treat the gifts as being split between them. However, husband's gift tax return reported his portion of the total transfer to the trust to be 3/4 (rather than 1/2) of the amount actually transferred to the trust. Wife's gift tax return reported her portion of the total transfer to the trust to be 1/4 (rather than 1/2) of the amount transferred to the trust. No amount of either husband's or wife's available GST exemption was allocated to the transfers on the gift tax returns.

Several years later, after discovering the error, the accounting firm advised husband of the ability to make a late allocation of GST exemption to the trust. The accounting firm prepared husband's new gift tax return to include the late allocation of GST exemption to the original transfers to the trust. The late allocation of husband's GST exemption erroneously allocated an amount equal to 100% of the value of the initial transfers to the trust with such value determined as of the effective date of the allocation. The notice of allocation attached to the new gift tax return stated that, as a result of the late allocation, the inclusion ratio of the trust was zero. Wife was not advised to make a late allocation of GST exemption to wife's portion of the initial transfers to the trust.

A ruling was requested that because the period for the assessment of gift tax had expired, the husband was to be treated as the transferor of the amount reported for husband's portion of the initial transfers on the initial gift tax return. In addition, rulings were also requested that the wife was to be treated as the transferor of the amount reported for wife's portion of the initial transfers to the trust on wife's initial gift tax return and that an extension of time would be granted to wife's estate to make a timely allocation of GST exemption to wife's portion of the initial transfers to the trust.

The Service ruled that because the time had expired under Section 6501 as to when a gift tax may be assessed, the husband was treated as having transferred 3/4 of the total amount to the trust and wife was treated as having transferred 1/4 for gift tax purposes.

However, under Treas. Reg. § 26.2652-1(a)(4), husband is regarded for generation-skipping tax purposes as the transferor of 1/2 of the total value of the property transferred to the trust regardless of the interest that husband was treated as having transferred for gift tax purposes. As a result, husband's late allocation of the GST exemption of the trust on the Form 709 was effective only to 1/2 of the property transferred to the trust. The Service granted the request of wife's estate for an extension of time to allocate GST exemption to the trust for her portion. It found that the requirements of Treas. Reg. § 9100-3 had been met. Under this regulation, requests for relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional. Wife's GST exemption would be allocated to 1/2 of the transferred property and the allocation would effective as to the date of the transfer to the trust.

40. Letter Ruling 201736017 (Issued June 1, 2017; Released September 8, 2017)

IRS permits an extension of time to elect out of the automatic allocation rules with respect to GST tax

Grantor and grantor's spouse established an inter vivos irrevocable trust for the benefit of their three children. Each of the trusts had the potential for the imposition of GST tax. An accounting firm discussed and advised the grantor of the automatic allocation of GST exemption rules and the ability to elect out. The accounting firm prepared the gift tax returns that included an election out of the automatic allocation rules for the current gifts and all future gifts to the trust. As a result of errors by the accounting firm, however, the gift tax return was not timely filed. Consequently, the grantor failed to elect out of the automatic allocation rules for the gifts to the trusts.

Grantor requested an extension of time to elect out of the automatic allocation rules The IRS granted the request for an extension of time to elect out of the automatic allocation rules. It found that the requirements of Treas. Reg. § 301.9100-3 were met. Under this Treasury Regulation, a request for relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

41. Letter Ruling 201737006 (Issued June 12, 2017; Released September 15, 2017)

Extension of time to opt out of automatic allocation rules for GST exemption permitted

Taxpayer created an irrevocable family trust after December 31, 2000 that had the potential to be subject to GST tax. On the same date, taxpayer established a grantor retained annuity trust. Under the terms of the grantor retained annuity trust, taxpayer's retained interest terminated and any remaining principal passed to the family trust at the end of the second year. For GST tax purposes, the estate tax inclusion period for the grantor retained annuity trust closed on the date of the termination of the grantor's annuity interest. The taxpayer did not intend for the family trust to benefit the grandchildren and did not intend to allocate as GST exemption to the transfers to the GRAT and family trust.

The taxpayer engaged an accounting firm to prepare all the federal and state tax filings. The accounting firm inadvertently reported the transfers to the GRAT and family trust on Schedule A, Part 1 of the gift tax return (gifts subject only to gift tax) instead of Schedule A, Part 3 (indirect skips). In addition, the accounting firm failed to advise the taxpayer of the opportunity to elect out of the automatic allocation rules for the GST exemption. The taxpayer requested an extension of time to opt out of the automatic allocation rules. The Service held that Treas. Reg. § 301.9100-3 would apply. Under this regulation, a request for relief will be granted when the taxpayer provides evidence that the taxpayer acted reasonable and in good faith and that the grant of the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a tax professional.

42. Letter Ruling 201737007 (Issued June 1, 2017; Released September 15, 2017)

IRS permits taxpayer to opt out of automatic allocation GST exemption

Grantor and grantor's spouse establish an inter vivos irrevocable trust for the benefit of each of their three children. Each trust had the potential for GST tax. An accounting firm discussed and advised the grantor about the rules regarding the automatic allocation of GST exemption and the ability to elect out of those rules. The accounting firm prepared a gift tax return that included an election out of the automatic allocation of GST exemption. However, the accounting firm failed to file the gift tax return on time and therefore the opt-out of the automatic allocation failed.

The grantor requested an extension of time to elect out of the automatic allocation rules. The Service granted the request, citing Treas. Reg. § 301.9100-3. That regulation provides that requests for relief will be granted if the taxpayer shows that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

43. Letter Rulings 201743004 and 201743005 (Issued July 3, 2017; Released October 27, 2017)

IRS allows extension to elect out of the automatic allocation of GST exemption rules

Taxpayer created a trust for the benefit of his descendants and family members prior to January 1, 2001. The trust had GST tax potential. Taxpayer made an annual transfer to the trust and its successor in each year from Year 1 through Year 13. In reporting the transfers, Taxpayer and Taxpayer's Spouse split the gifts. The gifts were reported on a timely filed Form 709.

The returns filed for Year 1 and Year 10 include election out statements, providing that Taxpayer was electing out of the automatic allocation of GST exemption with respect to the gifts to the trust. However, the returns filed for Year 2 through Year 9 did not include the election out statements to avoid the automatic allocation of GST exemption. Subsequently in Year 11, Taxpayer created Trust B for the benefit of his issue. Trust B had GST tax potential. On the same date, the trustee of Trust A exercised the power provided under state law to transfer the Trust A principal to Trust B, and the Trust A principal thereupon became the principal of Trust B. Taxpayer made an annual transfer to Trust B in each of Year 11 through Year 13. These gifts to Trust B were split by Taxpayer and Taxpayer's Spouse. These returns did not include an election out statement to avoid the automatic allocation of GST exemption to the transfers that Trust B reported.

Taxpayer requested an extension of time to have the automatic allocation rules not apply to the transfers made to Trust A and Trust B for the years in question. An extension of time to opt out of the automatic election rules will be granted under Treas. Reg. § 301.9100-3 when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

In this situation, the government concluded that Taxpayer's returns filed for Year 1 and Year 10 included effective elections out of the automatic allocation rule with respect to the gifts reported therein. Furthermore, the taxpayer was granted an extension of time to make the opt-out election for Year 2 through Year 9 and for Year 11 through Year 13.

44. Letter Rulings 201731005 and 201731010 (Issued April 3, 2017; Released August 4, 2017)

Taxpayer found to have complied with the essential requirements necessary to allocate GST exemption to irrevocable trust

These two letter rulings have the same facts. Husband created an irrevocable trust for the benefit of his descendants. Husband and Wife hired an attorney to prepare the gift tax returns. On each return, Husband and Wife signed their consent to treat the transfers as having been made one half by each spouse under Section 2513. Husband elected out of the automatic allocation rules with respect to the gift to the trust that year. The attorney preparing the gift tax return for Husband correctly reported the transfer to the trust as an indirect gift. The attorney also allocated GST exemption to the transfer on Schedule B, Part 2, line 6; however the attorney failed to attach a Notice of Allocation for this transfer. Because Husband elected out of the automatic allocation rules, Husband could still allocate GST Exemption by properly reporting the allocation on a timely filed gift tax return which Husband did. Husband failed to attach a Notice of Allocation of GST Exemption in accordance with the instructions for Form 709. As a result, Husband failed to literally comply with the instructions for the gift tax return or with the requirements and the regulations for allocating GST exemption to an indirect skip in accordance with Section 2632(c).

The ruling noted that literal compliance with the procedural instructions to make an election is not always required. Elections may be treated as effective where the taxpayer complied with the essential requirements of the regulations (or the instructions to the applicable form) even though the taxpayer failed to comply with certain procedural directions therein. Hewlett Packard Company v. Commissioner, 67 T.C. 736 (1977). As a result, the Service ruled that the gift tax return submitted by Husband contained sufficient information to constitute substantial compliance with the requirements of Section 2632(c) to allocate GST exemption to an indirect skip and, therefore, Husband allocated GST exemption to the transfer to the trust.

45. Letter Ruling 201735009 (Issued May 25, 2017; Released September 1, 2017)

Judicial reformation of trust will not subject the trust to GST tax

This letter ruling involved a pre-1985 grandfathered GST irrevocable inter vivos trust that was for the primary benefit of Son and Son's issue. Pursuant to a power to amend the trust, a trust committee amended the trust several times prior to September 25, 1985. The committee also amended the trust subsequently to September 25, 1985. One change made by one amendment to add an additional relative of the grantor as a beneficiary would arguably extend the term of the trust. Subsequently, the trustees of the trust sought a judicial construction of the effect of the amendment adding the additional relative, to specifically find that the addition of the relative as a contingent beneficiary would not add the relative as a measuring life in determining the duration of the trust, and under the state common law rule against perpetuities, the amendment was void ab initio and that state law prohibited the use of the additional relative from being a measuring life. The court construed the trust as requested.

The trustee now requested a ruling that the amendment to the trust and the subsequent court construction of the trust did not cause the trust to lose its exemption from GST tax. The IRS noted that the amendment to the trust to add the additional relative as a contingent beneficiary created an ambiguity but that the court issue an order construing the amendment to assent to be sure that the additional relative was not treated as a measuring life for purposes of determining the duration of the trust. As a result, the trust would not be subject to additional GST tax and would retain its grandfathered status.

46. Letter Rulings 201814001 and 201814002 (Issued December 11, 2017; Released April 6, 2018)

Construction of ambiguous terms of grandfathered GST trust will have no adverse generation-skipping tax, gift tax, or income tax consequences

Settlor established an irrevocable trust for the benefit of his lineal descendants prior to September 25, 1985. Consequently, the trust was grandfathered from the GST tax. The current trustees of the trust were child, individual, and a bank. The terms of the trust were ambiguous. However, Settlor was currently living at the time of the ruling request and attested that at the time the trust was created and all times thereafter, Settlor intended for the trust only to benefit blood descendants. The trustees petitioned the State Court for declaratory judgments construing the ambiguous terms of the trust consistent with Settlor's intent to benefit only blood descendants and the State Court entered that order conditioned upon the trustees obtaining a favorable ruling by the Internal Revenue Service that the order would have no adverse generation-skipping tax, gift tax or income tax consequences.

The Service first ruled that the terms of the trust presented a bona fide issue regarding whether an adopted grandchild of the Settlor was considered a member of the class of issue, descendants, or children. It also ruled that the State Court's order construing the ambiguous terms was consistent with the applicable state law that would be applied by the highest court of the state. The Service here followed Treas. Reg. § 26.2601-1(b)(4)(i)(C) which provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument to correct a scrivener's error will not cause an exempt trust to be subject to the generation skipping tax if the judicial action involves a bona fide issue and the construction is consistent with the applicable state law that would be applied by the highest court of the state, pursuant to Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Here the declaratory judgment met the requirements of the Treasury regulations and the construction of the trusts would not affect its exempt status.

Next, the Service ruled that because the State Court's order clarified the ambiguous terms at issue, the order construing the ambiguous terms was not a transfer for gift tax purposes and was not a taxable gift pursuant to Section 2501. Finally, the Service ruled that because the State Court's order resolved an ambiguity as to the construction of the trust and carried out the intent of the Settlor rather than resulting in a disposition of the interest of the trust, there would be no realization of gain or loss to the trust for income tax purposes.

47. Letter Ruling 201818005 (Issued January 16, 2018; Released May 4, 2018)

Partition of trust in accordance with terms of partition order will have no adverse income, gift, or generation-skipping tax consequences

Grantor created a trust prior to September 25, 1985. Consequently, the trust was grandfathered from GST tax. The trust was created for the primary benefit of daughter, four grandchildren, and four great grandchildren. In a previous partition proceeding, the trust was divided along the family line into five separate trusts. In the ruling addressing that partition, the Service ruled that the first partition order would not cause the trust to realize gain or loss from any sale or disposition; would not result in a transfer by any beneficiary of the trust subject to the gift tax; and would not cause distributions from the trust to be subject to GST tax.

This later ruling request applied only to one of the five trusts. This trust was for the benefit of one granddaughter who had five living children. In the second partition order, the court modified the granddaughter's trust to provide that upon the death of the granddaughter, her trust would be equally divided or partitioned into separate trusts for the benefit of each living child of that granddaughter and for the benefit of each group comprised of the living descendants of a deceased child of the granddaughter per stirpes. The Service ruled that the modification of the granddaughter's trust would not be considered an exchange of property resulting in the realization of gain or loss. This was because there would be no material difference in the positions of the beneficiaries of the trust before and after the partition. In addition, there would be no adverse gift tax consequences.

With respect to the GST tax, the Service ruled that the fact pattern in this letter ruling was similar to Treas. Reg. § 26.2601-1(b)(4)(i)(E), Example 5. In that example, the Service stated that the division of a grandfathered irrevocable trust for the benefit of two children and their issue would not have adverse GST tax consequences upon a court-approved division of the trust into two equal trusts, one for the benefit of each child and his or her issue. This is because the division of the trust did not shift any beneficial interest in the trust to a beneficiary in a lower generation. In addition, the division would not extend the time for vesting of any beneficial interest in the trust beyond a period provided for in the original trust. Essentially the same fact pattern as in Example

5 applied here and the Service ruled that there were no adverse generation-skipping tax consequences.

48. Letter Ruling 201825007 (Issued March 15, 2018; Released June 22, 2018)

Modification of GST grandfathered trust will not affect exempt status

Decedent created a trust for the benefit of his daughter and her descendants through his will. Decedent died prior to December 26, 1985 and the trust was grandfathered from GST tax. The trust was initially administered in State A. The court in State A issued a final order modifying the method of determining the income of the trust. Under the modification, the trustees were to distribute an amount equal to the greater of the trust's annual net income or X percent of the total value of the trust determined on the first date of each year. This was done pursuant to a statute in State A. This order was contingent on the receipt of a favorable ruling from the IRS.

Subsequently, the situs of the trust was moved to State B. The corporate trustee now sought to modify the method for determining the trust income. Under the proposal, the annual distribution amount to be paid by the trustees would be a unitrust amount. The trustee also sought an ordering rule for determining the character of the annual trust distributions for income tax purposes in accordance with the State B's statute. In all other respects, the terms of the trust would be identical to the original trust.

In general, a modification of the governing instrument of an exempt trust will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who currently are the beneficiaries and the modification does not extend the time for vesting any beneficial interest in the trust beyond the period provided for in the original trust. See Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1). Based on examples in the treasury regulations, the IRS ruled that the proposed changes would not shift a beneficial interest to a beneficiary in a lower generation and would not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust. As a result, the modification of the method of determining trust income and the adoption of the ordering rule would not cause the trust to lose its GST exempt status.

49. Letter Ruling 201825023 (Issued March 9, 2018; Released June 22, 2018)

IRS grants decedent's estate an extension of time to sever a residuary trust into an exempt and non-exempt residuary trust

Upon decedent's death, the residue of decedent's revocable trust was to be held in a residuary trust that had GST tax potential. In addition, one paragraph of the trust directed the trustee to divide any trust into two separate sub trusts of equal or unequal value whenever the division was necessary or desirable to minimize transfer or other taxes. Finally, the trust provided that the trust should be construed in a matter consistent with decedent's objective of using all available GST tax exemptions and to have trusts that were either entirely exempt or entirely non-exempt.

The executors engaged a law firm to prepare a Form 706. An accounting firm was retained to advise the estate on income tax issues arising as a result of decedent's death. Neither the law firm nor the accounting firm advised decedent's estate of any gifts or distributions to grandchildren that would have a GST impact. Moreover decedent's estate was not advised to divide the residuary trust into separate exempt and non-exempt trusts to effect decedent's GST planning. The estate tax return was timely filed but did not evidence any attempt to divide the residuary trusts into exempt or non-exempt trusts. The executors requested an extension of time to sever the residuary trust into exempt and non-exempt trusts and a ruling that the automatic allocation rules would cause any unused portion of decedent's GST exemption to be allocated to the exempt residuary trust.

Treas. Reg. § 26.2654-1(b)(1)(ii) provides that the severance of a trust that is included in the transferor's gross estate into two or more trusts will be recognized for generation-skipping tax purposes if the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law. The terms of the new trust must provide for the same succession of interests and beneficiaries as provided in the original trust. The severance needs to occur prior to the date prescribed for filing the federal estate tax return for the estate of the transferor. The severance must occur on either a fractional basis or if a pecuniary basis severance is required, it meets the requirements for payments to individuals.

Based upon the facts submitted, the IRS concluded that the requirements of Treas. Reg. § 301.9100-3 were satisfied. This regulation provides that requests for relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer.

50. Letter Ruling 201732029 (Issued April 20, 2017; Released August 11, 2017)

Reformation of grandfathered GST Trust to correct scrivener's error will have no adverse estate, gift, or generation-skipping tax consequences

Decedent created an irrevocable trust prior to September 25, 1985 and thus the trust was grandfathered from GST tax. Under the terms of the trust, the income and principal of the trust was to be available for the son of the decedent and son's children during the lifetime of son. Upon the death of the son, the assets of the trust would to be divided into separate trusts equal in number to the then surviving children of son until each child reached the age of 30 years at which time one-half of the principal of the trust would be distributed to the child with the balance being distributed to the child at age 35. Son had three children of whom two children were now living and one child was deceased. The deceased child left three children of her own. As a result of a scrivener's error, upon son's death, the children of the predeceased granddaughter would not receive a distribution from the trust. In order to correct the scrivener's error, the trustee petitioned the county court to reform the provisions of the trust by removing the word "surviving" from the paragraph of the trust with respect to distributions to the son's children upon the death of the son.

Three rulings were requested:

- The proposed court reformation could not cause the trust to have any adverse GST tax liability;
- The proposed reformation would not result in any gift tax liability to the beneficiaries; and
- The proposed reformation would not result in any estate tax liability to the beneficiaries.

The IRS held that the court reformation would have no adverse tax consequences. It found that the reformation of the trust was consistent with applicable state law that would be applied in the highest court of the state. As a result, the proposed reformation would not cause the trust to lose its GST exempt status under Section 2601 or result in any GST tax liability to any beneficiary of the trust. Under Treas. Reg. § 26.2601-1(b)(4)(i)(C), a judicial construction of a governing instrument will not cause an exempt trust to be subject to GST tax if the judicial action involves a bona fide issue and the construction is consistent with applicable state law that would applied by the highest court of the state. Those conditions were met. The IRS also ruled that the proposed court reformation would have no estate or gift tax liability to the beneficiaries.

51. Letter Ruling 201735005, (Issued May 8, 2017; Released September 1, 2017)

Inadvertent payment by trust beneficiary of federal and state income taxes will not have adverse estate, gift, or GST tax consequences

This letter ruling involved a lifetime grandfathered GST irrevocable trust created prior to September 25, 1985. The trust was for the benefit of daughter and her issue. The trust was funded with shares of stock in an S corporation and was a qualified subchapter S trust.

Subsequent to the creation of the trust, the trustee sold the trust's shares of stock in the S corporation in a transaction that resulted in capital gains to the trust for federal and state tax purposes. Pursuant to state law, the capital gains should have been allocated to trust principal and all income taxes due on the capital gains were required to be paid from trust principal. However, the trustee issued a Schedule K-1 to the daughter which treated the capital gains as a taxable distribution to the daughter for both federal and state tax purposes.

After receiving the Schedule K-1 the daughter reported the entire amount of the capital gains on her individual federal and state income tax returns which she jointly filed with a spouse. The errors on the schedule K-1 were in Year 1. The trustee made an additional distribution to daughter in year 2 as a partial reimbursement for the income taxes erroneously paid by daughter and spouse. The daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

The trustee subsequently prepared a draft of its first accounting. Upon receipt of the draft accounting, daughter became aware that she was due an additional reimbursement from the trustee for the income taxes that she and her spouse in connection with the sale of the S corporation stock. The daughter sought a court order to have the trustee reimburse her spouse and her for the income taxes they paid in error.

The daughter also requested a ruling from the IRS that the inadvertent payment by the daughter of the federal and state income taxes would not constitute a constructive addition to the trust for generation skipping tax purposes and that the subsequent reimbursement to the daughter of the income taxes paid together with interest and attorney's fees would not cause any portion of the trust to be subject to GST tax. Rulings were also requested that the inadvertent payments would have no adverse estate and gift tax consequences.

The IRS ruled that there was no constructive addition to the trust for GST purposes that would cause the trust to lose its exemption. It noted that the daughter did not waive her right to recovery and petitioned the court to reimburse her for unreimbursed income taxes with interest and penalty and the Trustee had agreed to reimburse the daughter. Consequently, no addition to the trust occurred as a result of the daughter's inadvertent payment of the income taxes and the trust's prior reimbursement of income taxes and subsequent reimbursement under the court order for the income taxes together with interest and payment.

Also, since there was no change in beneficial interest or the beneficiaries and no transfer of property had occurred as a result of the inadvertent payment of the income tax and the reimbursement of income taxes, daughter did not make a gift to the trust for gift tax purposes.

Finally, since daughter did not transfer any property to the trust, Section 2036 would not apply to cause any property in the trust to be included in daughter's estate at her death since in order for Section 2036 to apply, there must be a transfer.

FIDUCIARY INCOME TAX

52. Letter Ruling 201807001 (Issued November 13, 2017; Released February 16, 2018)

IRS recognizes reformation of trust to qualify as a grantor trust for income tax purposes

Donor created a trust which he intended to be a grantor trust prior to August 20, 1996. The Donor was not a citizen of the United States. At the time Donor executed the trust, he was not married and had no issue. Subsequently, Donor married and had issue. None of Donor, Donor's spouse, and Donor's issue were ever United States citizens.

The trust, as originally drafted, provided that the independent trustee during the lifetime of Donor, could distribute the income and principal of the trust to or for the benefit of Donor and Donor's issue.

Prior to August 20, 1996, the trust was treated as a grantor trust for income tax purposes; however, as a result of the Small Business Job Protection Act in 1996, which became effective on August 20, 1996, the grantor trust rules only apply in computing the income of a citizen or resident of the United States. There was an exception that provides that a trust would be treated as a grantor trust if during the lifetime of the grantor distributions could only be made to a non-citizen grantor or the non-citizen spouse. As a result of the Small Business Job Protection Act, after August 20, 1996, the trust was no longer a grantor trust.

The grantor filed a reformation suit to eliminate the issue as beneficiaries of the trust so that the trust could be treated as a grantor trust for income tax purposes. The grantor and the attorney who drafted the trust testified that Donor always intended the trust to be a grantor trust from its inception and the court granted the request for reformation and the issue were eliminated as beneficiaries.

The IRS held that the transcripts and representations of the party showed that Donor intended that the trust be a grantor trust with respect to Donor and that this intent was not carried out in the trust agreement as a result of a mistake of fact or law. As a result, the trust reformation was to be taken into account as of the initial date of the trust, so that the exception would permit the trust to be a grantor trust for income tax purposes from inception.

53. Letter Ruling 201803004 (Issued September 28, 2017; Released January 19, 2018)

IRS grants extension to trust for charitable contribution election

The trustees of a trust made charitable contributions during Year 2. The trust filed a return for Year 1 treating the charitable contributions made in Year 2 as paid in Year 1. An exception in Section 642(c) permits a charitable contribution paid after the close of the taxable year and on or before the last day of the year following the close of that taxable year to be treated as paid during such taxable year if an election is made. This is permitted if an election is filed under Section 642(c). However, due to inadvertence, the Section 642(c) election was not included with the Year 1 Form 1041 return for the trust. The income tax return filed for Year 2 did not take a deduction for the charitable contributions made in Year 2.

In this letter ruling, the Service applied the provisions of Treas. Reg. § 301.9100-3, which states that a request for relief will be granted when a taxpayer shows that the taxpayer acted reasonably and in good faith and that grant of relief will not prejudice the interests of the government. The IRS found that these requirements were met without much discussion, and the trust could take the Section 642(c) deduction in Year 1.

54. Green v. United States, 880 F.3d 519 (10th Cir. January 12, 2018)

Income tax charitable deduction for non-grantor trust limited to trust's adjusted basis in properties donated to charity

David M. Green and Barbara A. Green created an irrevocable dynasty trust in 1993. The beneficiaries of the dynasty trust were the children and descendants and charity. The trust stated that a distribution could be made from the trust to charity, but only to the extent that the deduction would not prevent the trust from qualifying as an electing small business trust or an S corporation. The trust owned a single member limited liability company called GDT which was disregarded for income tax purposes.

Hob-Lob Limited Partnership ("Hob-Lob") owns and operates most of the Hobby Lobby retail stores located nationwide. The trust was a 99% limited partner in Hob-Lob. In 2003, GDT purchased 109 acres of land in two industrial buildings in Lynchburg, Virginia for $10.3 million. GDT obtained the money to purchase the property through a distribution from Hob-Lob to the trust in 2003.

On March 19, 2004, GDT donated 73 of the 109 acres of land and the two industrial buildings to the National Christian Foundation Real Property, Inc. The National Christian Foundation is a recognized charity. The trust reported that its adjusted basis in Virginia property was $10,368,113 on the date of the donation.

In 2002, GDT purchased a church building and several out buildings in Ardmore, Oklahoma for $150,000. Subsequently in 2004, GDT donated the Ardmore property to the Church of the Nazarene. Its adjusted basis in the property is $160,477 and the property had a fair market value of $355,000.

In June 2003, GDT purchased 3.8 acres of land in Texas for $145,000. On October 5, 2004, GDT donated the Texas property to Lighthouse Baptist Church. The trust reported that its adjusted basis in the Texas property was $145,180 and the fair market value of the property was $150,000 on the date of the donation.

In October 2005, the trust filed its income tax return for 2004. The return claimed a charitable deduction totaling $20,526,383. This included the donations of real property as well as a $1,851,502.42 donation to Reach the Children Foundation, Inc. The return reported the trust's total adjusted basis in the three donated real properties was approximately $10.7 million, and that the properties' fair market value at the time of the donation was approximately $30.3 million. At no point in 2004 or any other tax year did the trust report as its income the properties' unrealized appreciation of approximately $19.6 million. On October 15, 2008, the trust filed an amended Form 1041 claiming a refund from the Internal Revenue Service for $3,194,748 in income tax and increasing the trust's reportable charitable deduction from $20,526,383 to $29,654,233.

The IRS denied the refund claim by the trust. It stated that the charitable deduction for the real property donated in 2004 was limited to the basis of the property contributed. The Western District of Oklahoma granted partial summary judgment in favor of the trust, concluding the trust was statutorily authorized to take a deduction equivalent to the fair market value of the properties as of the time of the donation.

On appeal, the Circuit Court first looked at the language of Section 642(c)(1). It stated that the Section applies only to estates and trusts. The deduction is limited to any amount of gross income which pursuant to the terms of the governing instrument is paid for a charitable purpose. The Circuit Court then said that the central issue in this appeal is the amount of the deduction is under Section 642(c)(1).

The Circuit Court stated that there were four possible interpretations of the statutory language. One possible interpretation of the statutory phrase is that a charitable contribution must be made out of the gross income earned by the trust during the year in question.

A second possible interpretation is that a charitable contribution must be made exclusively out of gross income earned by the trust at some point in time, so long as that gross income is kept separate from the trust principal from the time it is earned until it is donated.

The third possible interpretation, and the one that both parties in the case appeared to urge, is that a charitable contribution need not be made directly from, but must instead simply be traceable to, current or accumulated gross income. If applied to contributions of real property, that would mean that the real property must have been purchased with, i.e. sourced from, the trust's current or accumulated gross income.

The fourth and final possible interpretation is that the amount of the charitable deduction is capped or limited by the amount of gross income earned by the taxpayer in the tax year in question.

Consequently, the statutory phrase "any amount of the gross income" was viewed by the Circuit Court as ambiguous.

The Circuit Court disagreed with the District Court's finding that the deduction should extend to the full amount of the fair market value of the donated property. Instead, it agreed with the IRS that the amount of the deduction should be limited to the adjusted basis in the property. The Circuit Court noted that because the trust never sold or exchanged the properties at issue and never realized the gains associated with their increases in market value, the trust was never subject to being taxed from those gains. Consequently, construing the Section 642(c)(1) charitable deduction to extend to unrealized gains would be inconsistent with the Internal Revenue Code's general treatment of gross income.

The Circuit Court found that until Congress acted to make clear that it intended for the Section 642(c)(1) deduction to extend to unrealized gains associated with real property originally purchased with gross income, that it cannot construe the deduction in that manner. It also noted that its interpretation found support in Mertens Law of Federal Income Taxation, which states that where appreciated property purchased from accumulated gross income is donated, the amount of the deduction is limited to the adjusted basis of the property rather than based on the fair market value of the donated property as well as, in part, in a decision dealing with the predecessor statute to Section 642(c)(1), W. K. Frank Trust of 1931 v. the Commissioner, 145 F.2d 411 (3d Cir. 1944). The Circuit Court also stated that if Congress had intended for the concept of "gross income" to extend to unrealized gains on property purchased with gross income, it would have said so.

The court finally rejected the argument of the trust that Section 512(b)(11) provided an alternative path for a deduction for charitable contributions by trusts that are sourced from unrelated business income. The trust argued that through the operation of Section 512(b)(11), its contribution of donated properties was deductible under Section 170. The Circuit Court rejected this theory, because the trust's claim for a refund made no mention of its Section 512(b)(11) legal theory, and this theory was never clearly raised and/or resolved by the District Court. The case was remanded to the District Court with directions to enter summary judgment in favor of the government.

55. Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, ____ N.C. ____ (2018)

N.C. Supreme Court holds that income taxation of out-of-state trust is unconstitutional

On June 8, the North Carolina Supreme Court affirmed the Court of Appeals' 2016 decision in Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, _____ N.C. _____ (2018), upholding the Court of Appeals' (and Business Court's) finding that North Carolina General Statute Section 105-160.2 is unconstitutional as applied to the Kimberly Rice Kaestner 1992 Family Trust. The trust challenged the state of North Carolina's imposition of income tax on the basis that the trust's sole tie to the state is the residency of the trust's beneficiary, which connection is insufficient to allow taxation under the due process and commerce clauses of the U.S. Constitution.

The trust sought a refund of over $1.3 million in income taxes paid to the state of North Carolina for tax years 2005 – 2008. Upon denial of the claim, the trust brought suit challenging the constitutionality of the statute, both on its face and as applied to the taxpayer (the trust). Each of the Business Court, Court of Appeals, and North Carolina Supreme Court focused on the unique facts of the case in finding that the statute is unconstitutional as applied to the trust.

The trustee, during the period taxes were assessed, was a resident of Connecticut, the trust was governed by New York law, and North Carolina's only connection to the trust was the residence of the beneficiary. Further, all custodians of the trust's assets were located in Massachusetts, while all documents related to the trust, such as ownership documents and financial and legal records, were kept in New York. Finally, distributions from the trust were in the discretion of the trustee, and no distributions were made to the beneficiary in North Carolina during the relevant period.

The North Carolina Supreme Court emphasized that its opinion is limited to an "as applied" standard, meaning the court considered only whether the statute is constitutional as applied to the trust. In responding to the trust's continued challenge to the constitutionality of the statute, on its face, the North Carolina Supreme Court noted the presumption that "any act passed by the legislature is constitutional" and "any individual challenging the facial constitutionality of a legislative act must establish that ***no*** set of circumstances exists under which the [a]ct would be valid" (emphasis added). Because the trust presented only facts and evidence relevant to it, the North Carolina Supreme Court did not (and could not) consider whether the statute is unconstitutional on its face.

It has long been settled that a trust has a separate existence from its beneficiary, and therefore income to the trust is separately attributed. In determining whether the statute is constitutional, as applied to the trust, the North Carolina Supreme Court evaluated the requirements of the due process clause, specifically that the entity being taxed must "purposefully direct its activities" at the state, and the activities must be sufficiently abundant that the entity invokes the benefits and protections of that state's laws. Therefore, in order to withstand this challenge, the presence of the trust beneficiary in the state must satisfy the "purposeful" requirement to allow taxation of the trust. The North Carolina Supreme Court concluded that the unilateral activity of the beneficiary did not satisfy this requirement.

Interestingly, Justice Sam Ervin, in dissent, noted the advancements of modern technology related to online and telephone communications, rather than in person. He opined a traditional analysis of physical presence in a state may need to be amended to reflect those changes in determining whether a taxpayer purposefully directs its activities to a state.

With the North Carolina Supreme Court's limited scope decision, as applied solely to the trust, taxpayers and advisers should carefully evaluate whether tax is due by a trust in North Carolina. For taxes already paid, and to the extent that a trust's *sole* connection with North Carolina is the residence of a trust beneficiary, the trustee should consider filing a claim for refund.

56. Fielding v. Commissioner, ____ Minn. ___ (July 18, 2018)

Attempt of Minnesota to tax irrevocable non-grantor trusts as resident trusts for state income tax purposes is unconstitutional under the due process clauses of United States and Minnesota Constitutions

Reid MacDonald, who was then domiciled in Minnesota, created four GST trusts on June 25, 2009. Each trust was initially funded with shares of nonvoting common stock in Faribault Foods, Inc. a Minnesota S Corporation. The original trustee for all four trusts was Edmund MacDonald, a California domiciliary. Reid MacDonald retained the power to substitute assets in the trusts. Consequently for the first thirty months of their existence, the trusts were "grantor type trusts". On December 31, 2011, Reid MacDonald relinquished his power to substitute assets in the trusts and the trusts ceased to be "grantor type trusts" and became irrevocable on December 31, 2011 (according to the court). Reid MacDonald was a resident of Minnesota at the time the trusts became irrevocable. As a result, each trust was then classified as a "resident trust" under Minn. Stat. § 290.01, subd. 7b(a)(2). Katherine Boone, a Colorado domiciliary, became the sole trustee for each trust on January 1, 2012.

Subsequently, the trusts filed Minnesota income tax returns as resident trusts, without protest, in 2012 and 2013. On July 24, 2014, William Fielding, a Texas domiciliary, became trustee of the trusts. Shortly thereafter, all of the shareholders, including the trusts, sold their shares in Faribault Foods, Inc. Because the trusts were defined to be Minnesota residents as a result of Reid MacDonald's Minnesota domicile in 2011, the trusts were subject to tax on the full amount of the gain from the 2014 sale of the stock as well as the full amount of income from other investments. The trusts filed their 2014 Minnesota income tax returns under protest, asserting that the Minnesota statute classifying them as resident trusts was unconstitutional as applied to them. The trusts then filed amended tax returns claiming refunds for the difference between the tax owed as resident trusts and the tax owed as non-resident trusts – a tax savings of more than $250,000 for each trust.

The Minnesota Commissioner of Revenue denied the refund claims and the Commissioner's decision was appealed to the Minnesota Tax Court on the grounds that the Minnesota statute violated the due process and commerce clauses of the United States and Minnesota constitutions. The trusts and the Commissioner each moved for summary judgment. The Minnesota Tax Court ultimately concluded that defining the trust as a resident trust based upon Reid MacDonald's Minnesota residency at the time the trusts became irrevocable violated the due process provisions of the Minnesota and United States constitutions. The Minnesota Tax Court stated that the grantor's domicile at the time the trust becomes irrevocable was not "a connection of sufficient substance" to support taxing the trusts. Having decided the case on due process grounds, the Minnesota Tax Court did not reach the Commerce Clause.

The Minnesota Tax Court noted that a state's tax will satisfy the due process clause if there is some minimum connection between the state and the entity subject to the tax and a "rational relationship" between the income that the state seeks to tax and the protections and benefits conferred by the state citing Luther v. Commissioner of Revenue, 588 N.W. 2d 502 (Minn. 1999).

The Minnesota Supreme Court framed the issue as whether Minnesota may permissibly tax all sources of income to the irrevocable trusts simply because it had classified the trusts as residents based on events that predated the tax year at issue.

The Minnesota Tax Commissioner cited the following as factors requiring taxation:

1. Reid MacDonald was a Minnesota resident when the trusts were created;
2. Reid MacDonald was domiciled in Minnesota when the trusts became irrevocable and was still domiciled in Minnesota in 2014;
3. The trusts were created in Minnesota with the assistance of a Minnesota law firm which drafted the trust documents and until 2014 retained the trust documents;
4. The trusts held stock in a Minnesota S Corporation;
5. The trust documents provided that questions of law arising out of the trust documents were to be determined in accordance with Minnesota law; and
6. One beneficiary had been a Minnesota resident through the tax years in question.

The trusts, on the other hand, noted that:

1. No trustee had been a Minnesota resident;
2. The trusts had not been administered in Minnesota;
3. The records of the trust assets and income were maintained outside of Minnesota;
4. Some of the trusts' income was derived from investments with no direct connection to Minnesota; and
5. Three of the four beneficiaries of the trusts lived outside of Minnesota.

The Minnesota Supreme Court concluded that the contacts on which the Tax Commissioner relied were either irrelevant or too attenuated to establish that Minnesota's tax on the trusts income from all sources complied with due process requirements. It first noted the grantor's connections to Minnesota were irrelevant. The relevant connections were Minnesota's connection with the trustee and not the grantor who established the trusts years earlier.

It noted also that the stock was an intangible asset and cited cases holding that states cannot impose an income tax on trust property because possession or control of these assets was held by trusts that were not residents of or domiciled in a state. In addition, the Minnesota residency of one beneficiary did not establish the necessary minimum connection to justify taxing the trusts income. The grantor's decision to use a Minnesota law firm and the contacts with Minnesota predating 2014 were irrelevant.

As a result, the contacts between the trusts and Minnesota from 2014 on were tenuous. The trusts had no contact with Minnesota during the applicable tax year. All trust administration activities by the trustees occurred outside Minnesota.

The Court also noted that these trusts were inter vivos trusts that had not been probated in Minnesota courts and had no existing relationship to the Minnesota courts distinct from that of the trusts and the trust assets unlike other cases which involved testamentary trusts such as District of Columbia v. Chase Manhattan Bank, 689 A. 2d. 539 (DC 1997).

Attributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the trusts from Minnesota during 2014.

57. Notice 2018-61, 2018-31 IRB (July 13, 2010)

IRS to issue regulations on effect of Section 67(g) on certain deductions for estates and nongrantor trusts

The U.S. Treasury Department and the IRS announced on Friday, July 13, 2018, that they intend to issue regulations on the impact of new Section 67(g) of the Internal Revenue Code of 1986 on certain deductions for estates and nongrantor trusts. Section 67(g) was added to the Code by the 2017 Tax Act (P.L. 115-97) and suspends temporarily miscellaneous itemized deductions.

Tax practitioners expressed concern that Section 67(g) might inadvertently eliminate the deduction for costs of estate and trust administration. Practitioners have also requested guidance on whether the suspension of miscellaneous itemized deductions prohibits trust and estate beneficiaries from deducting on their individual returns the excess deductions of the trust or estate incurred during the trust's or estate's final taxable year.

Treasury and the IRS have stated that forthcoming regulations will clarify that the costs of trust or estate administration are not miscellaneous itemized deductions suspended by Section 67(g). Treasury and the IRS have also stated that new regulations will address the impact of Section 67(g) on the ability of beneficiaries to deduct an estate's or trusts excess deductions upon termination of the estate or trust.

Under Section 67(e) of the Code, the adjusted gross income of an estate or nongrantor trust is computed in the same manner as that of an individual, with two exceptions. Section 67(e)(1) permits an estate or nongrantor trust to deduct in computing adjusted gross income the costs incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in the estate or trust. Such expenses generally include, for example, fiduciary compensation and court accounting costs. Section 67(e)(2) provides an exception for deductions allowable under Section 642(b) (relating to the personal exemption of an estate or nongrantor trust), Section 651 (relating to distributions of income to beneficiaries of simple trusts), and Section 661 (relating to distributions of income and principal to beneficiaries of complex trusts).

New Section 67(g) of the Code suspends the deduction for miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. Some practitioners expressed concern that Section 67(g) may inadvertently eliminate the ability of an estate or nongrantor trust to deduct the administration expenses described in Section 67(e)(1).

On the termination of a nongrantor trust or estate, Section 642(h) of the Code allows the beneficiaries succeeding to the property of the nongrantor trust or estate to deduct the trust's or estate's unused net operating loss carryovers under Section 172 of the Code and unused capital loss carryovers under Section 1212 of the Code. If an estate or nongrantor trust has deductions (other than deductions for personal exemptions or charitable contributions) in excess of gross income in its final taxable year, then Section 642(h) allows the beneficiaries succeeding to the property of the estate or trust to deduct such excess on their individual returns. Capital loss carryovers and net operating loss carryovers are taken into account in calculating adjusted gross income and are not miscellaneous itemized deductions. Section 67(g) therefore does not affect the ability of a beneficiary to make use of a capital loss carryover or net operating loss carryover received from an estate or nongrantor trust.

The excess deductions of an estate or nongrantor trust, however, are allowable only in computing taxable income and are not covered by an exception from miscellaneous itemized deductions in Section 67(b). Absent guidance to the contrary, the excess deductions of an estate or nongrantor trust are now disallowed by Section 67(g) for taxable years beginning after December 31, 2017, and before January 1, 2026. The inability of beneficiaries to claim excess deductions may create unwelcome and unanticipated consequences. For example, it could artificially affect timing of distributions, delay closing of estates, and create incongruity in the treatment of administration expenses — permitting them as deductions to an estate or trust but denying them when passed-out to beneficiaries.

Notice 2018-61 announces that Treasury and the IRS intend to issue regulations "clarifying that estates and nongrantor trusts may continue to deduct expenses described in Section 67(e)(1)" for taxable years during which Section 67(g) suspends miscellaneous itemized deductions. Estates and nongrantor trusts may rely on Notice 2018-61 in continuing to deduct expenses under Section 67(e)(1).

Notice 2018-61 includes a reminder that Section 67(g) does not affect the determination of administration costs defined in Section 67(e)(1) of the Code. Pre-existing law continues to apply to the identification of administration expenses under Section 67(e)(1), including the treatment of "bundled" trustee's fees.

Notice 2018-61 also notes that Treasury and the IRS are studying whether Section 67(e) deductions and other deductions that would not be considered miscellaneous itemized deductions to an estate or nongrantor trust should continue to be regarded as miscellaneous itemized deductions when included by a beneficiary as an excess deduction under Section 642(h)(2). Treasury and the IRS intend to issue regulations addressing whether a beneficiary may claim the excess deductions of a terminating estate or trust notwithstanding the suspension of miscellaneous itemized deductions under Section 67(g). In connection with the drafting of new regulations, Treasury and the IRS are seeking public comments on whether amounts deductible under Section 642(h)(2) of the Code should be analyzed separately from other miscellaneous itemized deductions when applying Section 67 of the Code. Notice 2018-61 does not provide a timeframe for when Treasury and the IRS may issue new regulations.

ASSET PROTECTION

58. Georgia House Bill 441

Georgia Governor vetoes domestic asset protection trust legislation

In late March, the Georgia House of Representatives (by a vote of 103-56) and the Georgia Senate (by a vote of 43-6) passed HB 441, which would have made Georgia the 18th state to permit self-settled domestic asset protection trusts or DAPTs. Currently, 17 states — Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming — have enacted

DAPT-enabling legislation. Georgia, however, did not join their ranks, because on May 8, Gov. Nathan Deal vetoed HB 441.

Under current Georgia law, spendthrift provisions in a trust that shield the trust's assets from certain creditors are enforceable if the trust is settled by someone other than the trust's beneficiaries. HB 441 would have gone further, as the other DAPT states have done, by providing creditor protections to an irrevocable trust even if the settlor is also a beneficiary of the trust.

Deal indicated in his veto statement that he was open to further negotiations on this issue. However, the version of the bill Georgia's governor rejected already contained remarkably large gaps in the creditor protection that HB 441 supposedly would have provided. Tort, child support, and spousal claims, for instance, were completely exempted. Secured creditors also enjoyed an exemption for assets specifically pledged by a debtor. That left credit card and medical claims as perhaps the only types of debt that HB 441 would have allowed a settlor to avoid.

It is also worth noting that, with this veto, Deal has strengthened Georgia's standing as one of the most creditor-friendly states in the country. Further, in 2015, Georgia enacted the Uniform Voidable Transfer Act (UVTA). Under the UVTA, creditors may avoid certain transfers made by an insolvent debtor by using the less-onerous preponderance-of-the-evidence standard, as opposed to the clear-and-convincing standard used in many jurisdictions. The UVTA also makes it more difficult for debtors, and the trusts they settle, to start the statute-of-limitations clock for allegedly voidable transfers.

Deal's veto of HB 441 appears to continue Georgia's generally creditor friendly legal tradition.

59. Toni 1 Trust v. Wacker, ___ AK ___ (March 2, 2018)

Alaska Supreme Court determines that Alaska state courts do not have exclusive jurisdiction over fraudulent transfer actions under AS 34.40.110(k)

Donald Tangwall sued William and Barbara Wacker in Montana state court in 2007. The Wackers counterclaimed against Tangwall, his wife, Barbara Tangwall, his mother-in-law, Margaret "Toni" Bertran, and several trusts and businesses owned or run by the Tangwall family. As a result, several default judgments were entered against Donald Tangwall and his family.

In 2010, before the issuance of the last of the default judgments, Toni Bertran and Barbara Tangwall transferred parcels of real property to an Alaskan trust called the "Toni 1 Trust" which was an Alaska self-settled domestic asset protection trust." The Wackers filed a fraudulent transfer action under Montana law in Montanan state court alleging that the transfers were fraudulent and default judgments were entered against Barbara Tangwall, the Toni 1 Trust, and Toni Bertran.

After the issuance of the fraudulent transfer judgments by the Montana court, the Wackers purchased Barbara Tangwall's one half interest in one of the parcels at a sheriff's sale in partial satisfaction of their judgment against Donald Tangwall and the family. Before the Wackers could purchase the remaining half interest, Toni Bertran filed for Chapter 7 bankruptcy in Alaska. As a result, her interest in the property in the Toni 1 Trust was subject to the jurisdiction of the federal bankruptcy court.

In December 2012, Donald Tangwall, as trustee of the Toni 1 Trust, filed a complaint in the bankruptcy court alleging that the service on the trust in the Montana fraudulent transfer action was defective, which rendered the judgment against the trust void. However, rather than litigate the issue of service in Montana, the bankruptcy trustee brought a fraudulent transfer claim against Tangwall under the federal bankruptcy fraudulent transfer statute. The bankruptcy court entered a default judgment against Tangwall, which judgment was sustained upon appeal.

Tangwall then sought relief in Alaska state court in which he argued that AS 34.40.110 granted Alaska courts exclusive jurisdiction over any fraudulent transfer actions against the trust. On this basis, Tangwall sought a declaratory judgment stating that all judgments against the trust from other jurisdictions were void and that no future actions could be maintained against the trust because the statute of limitations had run.

The Alaska Superior Court dismissed this complaint and Tangwall appealed. The Alaska Supreme Court found that AS 34.40.110(k) could not limit the scope of the jurisdiction of other states. Citing Tennessee Coal, Iron and Railroad Company v. George, 233 U.S. 354 (1914), the Court held that states are not constitutionally compelled to acquiesce to sister states' attempts to circumscribe their jurisdictions over actions. It stated that Tennessee Coal held that the Full Faith and Credit Clause of the United States Constitution does not compel states to follow another state's statutes claiming exclusive jurisdiction over suits based on a cause of action "even though the other state created the right of action." The Court did acknowledge that the Alaska legislature attempted to grant Alaska courts exclusive jurisdiction over claims against an Alaska self-settled domestic asset protection trust. It also acknowledged that several other states had similar statutes and that similar statutes do restrict their jurisdiction. However, the court found that under Tennessee Co, the assertion of exclusive jurisdiction did not render a fraudulent transfer judgment against an Alaskan trust from a Montana court void for lack of subject matter jurisdiction.

In addition, the court found that it could not grant Tangwall relief under federal judgment. It noted that Tennessee Coal only addressed the state's ability to restrict the jurisdiction of sister states. However, Marshall v. Marshall, 547 U.S. 293 (2006), concluded that state efforts to limit federal jurisdiction were invalid even though the state created the right of action that gave rise to the suit. It noted that AK 34.40-110(k) purported to grant Alaska courts exclusive jurisdiction over all fraudulent transfer claims against Alaska self-settled domestic asset protection trusts. Because 28 U.S.C. § 1334(a) gives federal courts' jurisdiction over some of these claims, the Alaska law conflicted with federal law to the extent that it was impossible to comply simultaneously with both. Consequently, under the Supremacy Clause of the Constitution, state courts are precluded from limiting federal jurisdiction. Therefore, relief could not be granted to Tangwall from the federal judgment.

60. In re Olson, ___ F. Supp. 3d ___ (C.D. Cal 2018)

U.S. District Court declines to approve settlement of bankruptcy trustee with respect to offshore trust

In 2010, Jana W. Olson was sued in California Superior Court by Passport Management LLC. Within a month of the service of the lawsuit, Olson transferred her beneficial interest in a self-settled Cook Islands offshore asset protection trust from herself to her two minor children for no consideration. This transfer had the appearance of a fraudulent transfer. Subsequently, Olson filed a petition for bankruptcy. Passport Management LLC became the primary creditor of the bankruptcy estate.

At some point, Olson agreed to repatriate the money in the self-settled Cook Islands trust and a stipulated order was entered by the bankruptcy court directing Olson to do so. The bankruptcy court's order specifically required repatriation but did not decide if the money was the property of the bankruptcy estate.

Olson then, according to the district court, proceeded to disobey the bankruptcy court's order by sabotaging the repatriation effort with a letter designed to convince the Cook Islands trustee that her request to repatriate the money was made under duress. As a result, apparently, the Cook Islands trustee refused to repatriate the money. The bankruptcy court then jailed Olson for more than a year for civil contempt. Eventually, the bankruptcy trustee decided that jail was not going to convince Olson to repatriate the funds in the trust from the Cook Islands. The bankruptcy trustee then negotiated an agreement with Olson and Olson's father and Olson's brother, as trustee of a new California trust with the two minor children as beneficiaries, under which the money would be returned to California with approximately 80 percent going to the bankruptcy estate and 20 percent to the California trust.

After the repatriation of the funds to California, the bankruptcy trustee moved for approval of the compromise agreement before the bankruptcy court. Passport Management opposed the motion claiming that there was no authority to disburse property of the bankruptcy estate in contravention of the priority rules and that, in any event, there was no reason to allow Olson effectively to be rewarded for her contempt. Passport Management LLC also argued that other pressure could have been brought to bear before a compromise was struck that allowed Olson or her family to retain part of the funds.

The bankruptcy trustee argued that the agreement was the only way to get property back into the reach of the United States court and that 80 percent was better than getting nothing at all. The trustee also believed that the fraudulent transfer claim could have been easily won, but that subsequent collection would have been virtually impossible because of the difficulty of seeking collection in the Cook Islands. As a result, the bankruptcy court granted the motion to approve the compromise, but declined to determine whether the trust funds held in the Cook Islands were always the property of the bankruptcy estate.

The district court rejected the compromise. First, the court said that without a judgment avoiding the transfers, the Cook Islands funds were not a part of the bankruptcy estate at the time of the petition. The transfers would have to be formally avoided through a fraudulent transfer claim to make the funds part of the bankruptcy estate. In addition, the bankruptcy court had no equitable duty to approve the compromise after Olson and her family arranged for the repatriation money in reliance on the settlement. This effectively minimized the independent role of the bankruptcy court in the process. The court also agreed with Passport Management that a benefit to Olson's minor children was an indirect benefit to Olson herself as the money set aside in trust was money that Olson did not have to pay for her children's welfare. The court then rejected the argument of the bankruptcy trustee that the minor children might be individually liable for their mother's debt as beneficiaries of the trust. The court noted that the normal rule is that beneficiaries are not liable for the wrongful acts of the trust. As a result, the district court rejected the settlement agreement.

FIDUCIARY CASES

61. In re Matter of the Estate of Anne S. Vose v. Lee, 390 P.3d 238 (Okla. Jan. 17, 2017)

Decedent's executor had a fiduciary obligation to the surviving spouse to file an estate tax return to elect portability of the deceased spousal unused exclusion amount even though under a premarital agreement the surviving spouse was not an heir or distributee of the decedent's estate

Facts: Anne S. Vose (the "Decedent") died intestate on January 22, 2016. The Decedent and her surviving spouse, C.A. Vose, Jr. ("Vose"), had entered into a premarital agreement on May 24, 2006 (the "Premarital Agreement"). Under the Premarital Agreement, Vose relinquished all his rights to take as an heir or distributee from the Decedent's estate.

After concluding a dispute regarding the validity of a purported will the Decedent had executed in 1995, the District Court of Oklahoma County, Oklahoma, appointed Robert E. Lee, III ("Lee"), the Decedent's son from a previous marriage, as the Decedent's intestate administrator.

Through a principle known as "portability," Section 2010 of the Internal Revenue Code allows the executor of the estate of a deceased spouse, or certain other individuals, to make an election to allow the surviving spouse to use the deceased spouse's unused estate tax exemption (the "DSUEA"), for purposes of the surviving spouse's gifts during life and upon death.

On August 10, 2016, Vose filed an application to the District Court asking the Court to compel Lee to file an estate tax return to elect portability. The District Court granted the application. Lee appealed, alleging that (1) the District Court lacked subject matter jurisdiction, (2) federal law preempted the District Court's order, (3) Vose lacked standing because of the Premarital Agreement, and (4) the District Court's order violated the Premarital Agreement.

Law: Congressional preemption of state law occurs when:(1) express statutory language indicates Congress intends to preempt state law, (2) the existence of a pervasive regulatory scheme implies Congress intended for federal law to occupy the field, (3) it is impossible to comply with both state and federal law, or (4) state law thwarts the purposes of federal law.

Under Oklahoma law, standing in a probate proceeding requires the party have a pecuniary interest in the decedent's estate. Standing does not necessarily require an interest as an heir or distributee, but requires only a financial interest in the outcome of the dispute concerning the decedent's estate.

Under Oklahoma law, a premarital agreement is generally effective to waive marital rights to property, whether created by statute or otherwise. However, under Oklahoma law, a contract cannot waive future rights of which the parties have no actual or constructive knowledge or notice.

According to Oklahoma law, an executor or administrator has a fiduciary obligation to all parties interested in the estate to administer faithfully the estate's property and preserve it from damage, waste, and injury.

Holding: The Supreme Court of Oklahoma upheld the District Court's order requiring Lee to file an estate tax return to elect portability. The Supreme Court held that Section 2010 of the Internal Revenue Code does not preempt Oklahoma law. Nothing in Section 2010 demonstrates Congressional intent for federal law to occupy the field of fiduciary obligations with respect to tax elections, supplants Oklahoma law governing the fiduciary obligations of an executor or administrator, or makes it impossible for a fiduciary to comply with both Oklahoma law and the federal requirements of making the portability election. The District Court did not lack subject matter jurisdiction over Vose's petition and federal law did not preempt the District Court's order because Vose's claims concerned only Lee's state law fiduciary obligations.

The Supreme Court also held that Vose possessed standing to file his application to compel Lee to elect portability. Although Vose waived his rights as an heir and distribute of the Decedent's estate in the Premarital Agreement, the portability election still had pecuniary value to Vose. The Court held that Vose did not waive his right to the DSUEA in the Premarital Agreement because the DSUEA did not exist at the time Vose and the Decedent executed the Premarital Agreement. Finally, the Supreme Court held that the District Court could compel Lee to file an estate tax return to elect portability of DSUEA because Lee had a fiduciary obligation to all persons interested in the estate, not just the estate's distributees.

In its analysis, the Court treated the DSUEA as an asset of the Decedent's estate that Lee, as the administrator, had a duty to protect. The Supreme Court also upheld the District Court's order requiring Vose, rather than the estate, to pay the costs of preparing and filing the estate tax return.

Practice Point: Under Oklahoma law, the DSUEA may now be a property right of the surviving spouse. Accordingly, practitioners representing couples whose net worth exceeds the federal basic exclusion amount should address the DSUEA in any marital or premarital agreements, as well as in estate-planning documents.

Practitioners should also consider amending existing marital agreements to incorporate provisions addressing the DSUEA. Marital agreements and estate-planning documents should explicitly state whether a spouse is waiving portability of the DSUEA, whether the executor of the first spouse to die has a duty to elect portability, and who should bear the cost of electing portability.

The Supreme Court also held that Lee owed fiduciary duties not just to the estate's beneficiaries, but also to "all parties having an interest in the estate." When drafting estate-planning documents, practitioners should also consider stating explicitly that the executor or trustee owes no fiduciary duties to a surviving spouse who is not otherwise a beneficiary merely because the fiduciary's decision whether or not to elect portability affects the surviving spouse.

62. Du Pont v. Wilmington Trust Company, C.A. No. 12839-VCS (Del. Ch. Oct. 6, 2017)

Delaware Chancery Court refuses to grant trust beneficiary's petition to remove the trustee of five directed trusts when the grounds for removal did not relate directly to matters of trust administration

Facts: Douglas W. du Pont ("du Pont") was the beneficiary of four trusts created under agreement and one under a will (collectively, the "Trusts") for the benefit of himself and his descendants. Wilmington Trust Company, N.A. ("Wilmington Trust"), was the trustee of the trusts and had been since inception of the Trusts in the 1940s and 1950s. Each of the Trusts were total return unitrusts governed by Delaware law. At the inception of the Trusts, Wilmington Trust was closely associated with the du Pont family, many of whose members participated in the management of Wilmington Trust. During the 2008 financial crisis, Wilmington Trust was the subject of government investigations and litigation. M&T Bank, a New York corporation, subsequently acquired Wilmington Trust. No du Pont family members remained involved in the management of Wilmington Trust after the acquisition.

In 2013, du Pont became dissatisfied with the investment performance of the Trusts and requested that Wilmington Trust petition the Delaware Court of Chancery (the "Court") to amend the Trust instruments to incorporate directed trustee provisions. Wilmington Trust complied with du Pont's request. The Court granted Wilmington Trust's petition and appointed du Pont as the investment director of each of the Trusts.

In addition to serving as trustee of the Trusts, Wilmington Trust also advised du Pont regarding his personal estate planning. At the advice of Wilmington Trust, du Pont made gifts to irrevocable trusts for his children naming Wilmington Trust as trustee. Du Pont claimed he would not have made these gifts had Wilmington Trust informed him that the trusts did not include his wife as a permissible beneficiary. Wilmington Trust also made loans to du Pont, and du Pont pledged personal assets as collateral for these loans. When du Pont became unable to repay the loans, Wilmington Trust reduced his unitrust payout and liquidated low-basis assets to reduce the principal balance of the loans. The liquidation of the low-basis assets resulted in millions of dollars of capital gains tax.

In February 2016, du Pont requested that Wilmington Trust resign as trustee of the Trusts. Wilmington Trust refused his request. The governing instruments of the Trusts contained no provision governing trustee removal. Consequently, in October 2016, du Pont petitioned the Court for removal of Wilmington Trust.

In support of his petition for removal, du Pont alleged that (1) there was a substantial change in circumstances since Wilmington Trust was appointed trustee, (2) hostility between Wilmington Trust and du Pont interfered with proper administration of the Trusts, and (3) Wilmington Trust was unfit, unwilling, and unable to administer the Trusts because it miscalculated the amount of his unitrust distribution, did not sufficiently communicate with him, and rejected his reasonable request for money to cover tax liabilities. Wilmington Trust filed a motion to dismiss du Pont's petition for failing to state a claim for relief.

Law: Under 12 Del. C. § 3327(3), the Court may remove a trustee, even in the absence of a breach of trust, when (1) there has been a substantial change in circumstances, (2) the trustee is unfit, unwilling, or unable to administer the trust properly, or (3) when hostility between the trustee and beneficiaries threatens the efficient administration of the trust. The Court must have "due regard for the expressed intention of the trustor and the best interests of the beneficiaries."

In a case of first impression, the Court used the official comment to Section 706 of the Uniform Trust Code to interpret the meaning of "changed circumstances" under Delaware law. Changed circumstances for this purpose include a "change in the character of the service or location of the trustee" but do not include the "corporate reorganization of an institutional trustee."

Under Delaware law, a trustee is "unwilling" or "unable" to administer the trust properly when the trustee refuses to act or "exhibits a pattern of indifference." A trustee is "unfit" to act when the trustee does not treat the beneficiaries fairly or commits a breach of trust. Under Delaware law, a beneficiary's lack of confidence in the trustee or the existence of friction is not grounds for removal. A court may remove a trustee only when the hostility makes it impossible for the trustee to perform its duties.

Holding: The Court held that du Pont did not plead sufficient facts to state a claim for relief. M&T's acquisition of Wilmington Trust did not constitute a change of circumstances warranting Wilmington Trust's removal. According to the Court, du Pont failed to state how government investigations into Wilmington Trust's activities prevented it from discharging its duties as a trustee.

Additionally, Wilmington Trust did not exhibit a "pattern of indifference." Even though Wilmington Trust was a directed trustee with respect to investment decisions, it retained discretion over distribution decisions. The instruments for the Trusts required Wilmington Trust to consider beneficiaries' other resources when making distributions. Accordingly, Wilmington Trust acted within its discretion not to distribute funds to du Pont for tax liabilities. Furthermore, errors in calculating the unitrust payment did not amount to indifference.

The Court held that even if Wilmington Trust acted negligently in giving estate planning advice to du Pont, he failed to allege how negligent estate planning advice impacted Wilmington Trust's performance of trustee services. The Court also held that Wilmington Trust loaned money to du Pont under commercially reasonable terms and the loans did not amount to unfair treatment.

Finally, the Court held that du Pont failed to allege sufficient facts to show that friction between du Pont and Wilmington Trust made it impossible for Wilmington Trust to manage effectively the Trusts.

Practice Point: Delaware courts are unlikely to grant a petition to replace a trustee when the reasons given for the requested removal do not relate directly to issues of trust administration. In order to avoid uncertain and protracted court disputes, drafters of estate planning documents should also include provisions governing the resignation or removal of trustees and specify the circumstances under which a beneficiary may remove a trustee.

63. Saccani v. Saccani, No. C078958, 2016 WL 6068962 (Cal. Ct. App. Oct. 17, 2016)

California court interprets a shareholder agreement to permit a shareholder's pre-death transfer of shares to a revocable trust after that shareholder gave another shareholder the option to purchase the shares after the transferring shareholder's death, even though the shareholder agreement itself only authorized share transfers to trusts for the benefit of a shareholder's descendants

Facts: Donald, Ronald, and Gary Saccani inherited equal one-third interests in Saccani Distributing Company (the "Company") from their father, Albert Saccani. On December 30, 1991, Donald, Ronald, Gary, and each of their wives entered into the Second Amended and Restated Stock Purchase Agreement of the Company (the "Shareholder Agreement"). Section 1.01 of the Shareholder Agreement stated that "[n]o Shareholder shall gift, sell, pledge, encumber, hypothecate, assign or otherwise dispose of (collectively 'Transfer')" any interest in the Company unless permitted by the Shareholder Agreement. Section 1.02 of the Shareholder Agreement allowed the shareholders to make "Permitted Transfers" to each other, their descendants, and to estate planning trusts for their descendants. At the death of a shareholder, Section 3.02 of the Shareholder Agreement caused a deemed sale of the deceased shareholder's shares to the Company unless a Permitted Transfer occurred.

Donald Saccani and his wife Phyllis transferred all their shares in the Company to a revocable trust that gave Gary Saccani the option to purchase all of Donald's shares after Donald's death. Donald died in 2007, and Gary exercised the option granted under Donald's revocable trust in 2012.

In 2013, Ronald died, and his children Todd and Antonio Saccani inherited his shares in the Company. Todd and Antonio sued Gary, Gary's wife Jill, Donald's wife Phyllis, the trustee of Gary and Jill's revocable trust, and the trustee of Donald and Phyllis's revocable trust in California Superior Court, alleging that the transfer of Donald's shares to Gary violated the Shareholder Agreement.

Todd and Antonio argued that Section 1.02 of the Shareholder Agreement did not permit Donald to give Gary an option to purchase shares held in Donald's revocable trust agreement, because Section 1.02 only permitted transfers to estate planning trusts for the benefit of a shareholder's descendants. Accordingly, at Donald's death, a deemed sale of his shares to the Company should have occurred. Disagreeing with Todd and Antonio's reading of the Shareholder Agreement, the Superior Court found for the defendants. Todd and Antonio appealed.

Law: Under California law, a court should give effect to the mutual intent of the parties when interpreting a contract. When the language of a contract is clear, a court should determine intent from the language of the contract. If a contract does not provide specialized definitions for terms, a court should use the ordinary meaning of words when analyzing the contract.

Holding: The Third District Court of Appeal of California (the "Court") affirmed the Superior Court's decision and held that the option granted to Gary was a Permitted Transfer under the Shareholder Agreement. Section 1.01 of the Shareholder Agreement defined "Transfer" to include any attempt to "gift, sell, pledge, encumber, hypothecate, assign or otherwise dispose of" shares in the Company. The Court stated that, by granting Gary an option to purchase shares of the Company after his death, Donald had encumbered the shares. The act of encumbering the shares was a "Transfer" to Gary within the meaning of Section 1.01 and was a "Permitted Transfer" within the meaning of Section 1.02 because Gary was another shareholder of the Company. Accordingly, it did not matter that Section 1.02 restricted transfers to estate planning trusts only for the benefit of a shareholder's descendants, because a "Transfer" to Gary had taken place during Donald's lifetime. Furthermore, Section 3.02 allowed a Permitted Transfer to take effect at Donald's death, not just during Donald's lifetime.

Practice Point: When drafting or interpreting shareholder agreements (and contracts in general), advisors should pay careful attention to definitional provisions and how those definitions apply when used in all places in the agreement. Advisors should consider multiple factual scenarios and the effect of the definitions under each of those scenarios. The advisor's goal should be to make sure that under any scenario the definitions conform to the parties' intent and do not cause unintended results.

64. Gray v. Binder, 805 S.E.2d 768 (2017)

The Commissioner of Accounts had the authority to hear a petition filed by the administrator of an estate for advice and guidance regarding the interpretation of the will and the determination of the proper heirs of the decedent

Facts: Albert F. Bahnfleth died testate on July 19, 2012. His will, executed in 1966, was admitted to probate in the Circuit Court for Fairfax County, Virginia. Each of the named beneficiaries in Bahnfleth's will predeceased the decedent.

In Virginia, oversight of certain fiduciaries is conducted by the Commissioner of Accounts, an official who assists the local circuit court. The Administrator of Bahnfleth's estate requested guidance from, and a hearing before, the Commissioner of Accounts of Fairfax County, regarding the determination of the decedent's heirs and the interpretation of the will.

Under Virginia law, Bahnfleth's cousins were his intestate heirs. Steven C. Gray, the step-grandson of Bahnfleth, attended the hearing, claimed that Bahnfleth intended to leave him half of his estate. Bahnfleth's will in fact bequeathed a share of his estate to his step-daughter, and Gray's mother, Jean Gray, with the expressed "desire that [Jean] use it for the education of . . . Steven C. Gray." Bahnfleth's cousins argued that such language was precatory, and showed only an intent to benefit Jean.

In January 2015, the Commissioner issued a report holding that all bequests in Bahnfleth's will had lapsed, and that his estate passed pursuant to the laws of intestacy. Gray filed exceptions to the report, but the Fairfax County Circuit Court overruled the exceptions and entered an order confirming the report. Gray filed a motion to reconsider which the Circuit Court denied, holding that "the Commissioner of Accounts has properly interpreted the law on the applicable facts." The Circuit Court further denied Gray's Petition for Appeal and Petition for Rehearing.

On May 4, 2016, the Commissioner filed a routine debts and demands report with the Circuit Court, authorizing the Administrator to "distribute the remainder of the estate to the beneficiaries after the final payments of any administrative expenses and debts known to the fiduciary." Gray responded to the debts and demands report, and he challenged the jurisdiction of the Commissioner to issue its January 2015 report without an initial decree of reference from the Circuit Court.

The Circuit Court confirmed the May 2016 report. Gray then filed a motion for reconsideration and to vacate the January 2015 report and the May 2016 report. The Circuit Court suspended its order and granted the Commissioner leave to respond to Gray's motion for reconsideration. The Commissioner found that his office was vested with the "authority to hear any matter concerning settlement of a fiduciary's account." Upon the Commissioner's findings, the Circuit Court denied Gray's motion for reconsideration. Gray appealed.

Law: Pursuant to Section 64.2-1200 et seq. of the Code of Virginia, the Circuit Court is vested with jurisdiction over fiduciary matters, including the administration of estates. The office of the Commissioner of Accounts was established "to afford a prompt, certain, efficient, and inexpensive method" for the settlement of fiduciaries' accounts and distribution of estates. Carter's Adm'r v. Skillman, 60 S.E. 775, 776 (Va. 1980). However, the Commissioner serves to assist the court, not supplant it.

Holding: On appeal, the Supreme Court of Virginia considered whether the Commissioner exceeded his authority when, at the request of Bahnfleth's Administrator, he conducted a hearing and produced a report interpreting Bahnfleth's will and determining heirs without an order of reference to consider the request for aid and guidance from the Circuit Court.

The Supreme Court of Virginia held that the Commissioner had authority to interpret the will and determine the heirs without an order of reference from the Circuit Court. The Court held that, contrary to Gray's assertion that the Commissioner has limited probate jurisdiction, the Commissioner's authority with respect to the settlement of estates is an extension of the Circuit Court's jurisdiction. The Court held that the Commissioner of Accounts is not a lower tribunal of limited jurisdiction; instead, it provides supervision within the jurisdiction of the Circuit Court, and, pursuant to Section 64.2-1209 of the Code of Virginia, the Commissioner "may hear and determine any matter which could be insisted upon or objected to by an interested person if the commission of accounts were acting under an order of a circuit court." The Supreme Court of Virginia did not consider the merits of the Commissioner's findings regarding the will and the passing of Bahnfleth's estate intestate, noting that it does not have jurisdiction to review reports provided by the Commissioner of Accounts.

Practice Point: Fiduciaries should be cognizant that the Commissioner of Accounts is a resource to the fiduciary and may be a means of receiving advice and guidance where the fiduciary is unclear regarding the terms of and interpretation of will or trust documents. Particularly in light of this case, the Commissioner of Accounts can provide a practical venue for such guidance.

65. Lawson v. Collins, No. 03-17-00003-CV, 2017 WL 4228728 (Tex. App. Sept. 20, 2017)

An arbitration award is final and binding on all participating parties and has the effect of a court order, regardless of whether all parties agree to the terms of the arbitration award. Absent evidence of statutory grounds for overturning such award, or evidence that such award is the result of fraud, misconduct or gross mistake, an arbitration award will be affirmed and confirmed

Facts: Talferd Gabriel Collins died in 1997. Talferd's wife, Ella Lee Myers Collins, died in 2014, leaving a will dated May 14, 2012. Together they had eleven children. In her will, Ella named three of her eleven children – Boyd, Elizabeth, and Robert – as executors. Following application for probate of the 2012 Will, Alice Lawson (a daughter of Talferd and Ella) filed a petition asserting that (1) the 2012 Will was not valid because Ella lacked legal or testamentary capacity to execute the will and (2) the 2012 Will was executed due to fraud or undue influence of Boyd or Elizabeth. Alice further objected to the appointment of Boyd and Elizabeth as executors, and later amended her petition seeking admission of a supposedly lost will of Ella to probate.

In October 2015, the parties, Boyd, Elizabeth, Ronald, Silas and Alice, participated in mediation, which resulted in a Mediated Settlement Agreement ("MSA") that was signed by each participant in the mediation, the mediator, and the participant's attorneys. The terms of the MSA provided, inter alia, that Alice would withdraw her will contest and that "any disputes as to the wording of settlement documents or performance hereof shall be submitted to the Mediator, Claude Ducloux, for binding arbitration."

Following mediation, the parties were unable to agree on the terms of the longer form settlement and release documents contemplated by the MSA. Alice and Ronald refused to sign the settlement documents and refused to withdraw their will contest. Boyd and Elizabeth filed a motion to enforce the MSA and to enter judgment in accordance with its terms.

The trial court held a hearing and ordered the parties to submit their disputes for binding arbitration in accordance with the terms of the MSA. On the day before the hearing, Jeanie Carr (a daughter of Talferd and Ella) appeared for the first time in the probate proceedings to question the validity of the 2012 Will and to object to the enforcement of the MSA, stating that she should be allowed to participate in the arbitration.

The trial court instructed Jeanie that she could file her own pleadings challenging the 2012 Will and the appointment of executors, and making any other claims regarding Ella's estate. But the trial court found that (1) her claims did not preclude other heirs from entering a settlement agreement and (2) because she was not a party to the MSA, she had no standing to participate in the arbitration proceeding.

The arbitrator signed an Arbitrator's Award, including as an exhibit the final form of the settlement documents contemplated by the MSA as determined by the arbitrator. Alice opposed confirmation of the Arbitration Award and entry of judgment in accordance with its terms, filing petitions to vacate or set aside the Award and the MSA. The trial court signed an order confirming the Award and ordering that it be enforced on its terms. Alice appealed.

On a no-evidence motion for partial summary judgment that Boyd and Elizabeth filed, the trial court sustained objections to certain evidence Jeanie offered and granted summary judgment against her. Jeanie non-suited the remainder of her claims and appealed. The Court of Appeals consolidated Jeanie's and Alice's appeals.

Law: Pursuant to the Texas General Arbitration Act, a trial court must confirm the award unless grounds are offered for vacating, modifying, or correcting the award under Section 171.088 or 171.091 of the Texas Civil Practice and Remedies Code. A party may avoid confirmation of the arbitrator's award "only by demonstrating a ground expressly listed" in the statute. Hoskins v. Hoskins, 497 S.W.3d 490, 494 (Tex. 2016). The common law allows a court to set aside an arbitration award only if the decision is a result of "fraud, misconduct, or gross mistake as would imply bad faith and failure to exercise honest judgment." Riha v. Smuleer, 843 S.W.2d 289, 292 (Tex. App. – Houston [14th Dist.] 1992, writ denied).

Holding: On appeal, the Court of Appeals of Texas affirmed the trial court's order confirming the Arbitration Award and ordering it enforced in accordance with its terms.

On appeal, Alice first asserted that the trial court erroneously excluded evidence showing that Alice was coerced into signing the MSA and excluded a medical report showing that Alice was incompetent, making her participation in the mediation and arbitration void. However, the hearing record demonstrated that Alice failed to preserve a claim that the trial court erred in excluding the evidence and that the medical report was excluded on grounds of hearsay. Thus, the Court of Appeals overruled each issue. Alice further asserted that the Arbitration Award was not "final, appropriate, and/or binding" because she had not signed the settlement documents. However, the Court of Appeals held that the Award is binding, final and effective once it is signed by the arbitrator – it is akin to a court order.

With respect to Jeanie's appeal, the Court of Appeals held that Jeanie failed to present the trial court with admissible evidence to raise a genuine issue of material fact regarding whether the 2012 Will was a forgery and whether the 2012 Will was executed as a result of undue influence. The Court of Appeals examined and overruled each of Jeanie's contentions on the admission of evidence and expert testimony, finding that Jeanie failed to provide any valid arguments supporting her contentions. The Court of Appeals affirmed the trial court's summary judgment order.

Practice Point: Practitioners should develop a clear understanding of the procedural nature of mediation and arbitration proceedings with respect to estate administration under applicable law. It is important that the practitioner as well as the client understand the binding and final nature of a mediation settlement and/or arbitration award, and the scope of application of such a settlement or award, especially before proceeding through mediation or arbitration.

66. Ajemian v. Yahoo!, Inc. 84 N.E. 3d 766 (Mass. 2017), petition for cert. docketed sub nom. Oath Holdings, Inc. v. Ajemian (U.S. Jan. 19, 2018) (No. 17-1005)

The Stored Communications Act (the "SCA") does not prevent Yahoo!, Inc. ("Yahoo") from voluntarily disclosing emails from a decedent's account to the decedent's personal representatives at the request of the personal representatives; it remains to be settled whether the SCA compels Yahoo to do the same

Facts: John Ajemian died intestate, and his siblings, Robert Ajemian and Marianne Ajemian, were appointed as his personal representatives. Robert and Marianne asked Yahoo to provide access to the contents of John's e-mail account. Yahoo refused to release the contents of the account, although they did provide "subscriber information" upon Robert and Marianne obtaining a court order mandating disclosure to the account holder's personal representatives.

Robert and Marianne filed a complaint in the Probate and Family Court seeking a judgment that they were entitled to unfettered access to the messages in the account. Yahoo filed a cross motion for summary judgment arguing that the SCA prohibited the requested disclosure, and, even if it did not, Yahoo was permitted to deny access to, or even delete the contents of, the account at its sole discretion based on the service contract entered into at the time the e-mail account was created.

The judge granted Yahoo's motion for summary judgment solely on the basis that the SCA barred Yahoo from complying with the requested disclosure. Robert and Marianne appealed to the Massachusetts Appeals Court, and the Supreme Judicial Court of Massachusetts transferred the case to themselves as a matter of first impression.

Law: The SCA prohibits entities that provide "service[s] to the public" from voluntarily disclosing the "contents" of stored communications unless certain statutory exceptions apply. The "agency exception" allows a service provider to disclose the contents of stored communications "to an addressee or intended recipient of such communications or an agent of such addressee or intended recipient." The "lawful consent exception" allows disclosure "with the lawful consent of the originator or an addressee or intended recipient of such communication."

Holding: The Supreme Judicial Court of Massachusetts ruled that the SCA does not prohibit Yahoo from voluntarily disclosing the contents of an e-mail account to the personal representatives of the account holder's estate, because the lawful consent exception applies.

The Court found that the agent exception does not apply because personal representatives are not agents of the decedent, as they cannot be controlled by the decedent. However, the lawful consent exception does apply such that the personal representatives of a decedent can give lawful consent to release of the content of the account. The Court reasoned that to find otherwise would result in a class of digital assets—stored communications—that could not be marshalled by personal representatives. The Court found that this was not the intent of the SCA. Therefore, based on the Court's statutory interpretation analysis, personal representatives are capable of giving "lawful consent" to the disclosure on behalf of the account holder, and "actual consent" by the decedent is not required to qualify for the "lawful consent exception" under the SCA.

Because the lawful consent exception applies, Yahoo is not prevented by the SCA from releasing the contents of the account to the personal representatives. The Supreme Judicial Court of Massachusetts remanded the issue of whether Yahoo was compelled to release the contents of the account to the Probate and Family Court, but strongly signaled that if the lower court were to find that Yahoo was not compelled to release the contents, the Supreme Judicial Court of Massachusetts would overturn that ruling and compel Yahoo to release the contents of the account.

Practice Point: A ruling that the SCA does not prevent providers from releasing content is certainly helpful to fiduciaries, however, we need to wait to see what happens on appeal to the United States Supreme Court, and how the issue of whether the disclosure is compelled is decided. In the meantime, it remains important to remind clients to keep a list of accounts and passwords with their important documents, and to utilize, to the extent possible, features designed to allow a successor to control an account, like Facebook's "Legacy Contact" designation.

67. Higgerson v. Farthing, 2017 WL 4224476 (Va. Cir. Ct. 2017)

A Trustee was held liable for breach of fiduciary duty and for excessive fees where the trustee was unnecessarily engaged in aggressive day trading and margin trading and his fees were not reasonable in relation to the work actually required to fulfill his fiduciary duties

Facts: Upon the death of Ivan Higgerson, Philip Farthing became the trustee of a trust created for the benefit of Ivan's surviving spouse, Edith. Philip was an attorney, not a trained investor. As trustee, Philip engaged in extensive margin trading. At certain times, 100% of the stock account held by the trust was pledged to purchase additional stock on margin. Charles Schwab's algorithm identified Philip as a day trader.

In 2013, Philip made 2,500 trades during the calendar year, turning over the value of the portfolio approximately 55 times in that year, with little to no actual benefit. He did not disclose this information to Edith, nor did he inquire about other sources of income or assets available to Edith. Philip also did not disclose his method of calculating fees or his rate of pay. In one year he took $113,287.50 in fees, while, in the same year, cutting distributions to Edith from $80,000 to $0.

Overall, Philip took $1,057,000 in fees from the trust, which was equal to 38% of the total distributed to Edith. The trust agreement said the trustee should take "reasonable fees" but did not define the term. Philip claimed that his fees were based on a fee schedule used by his prior law firm. Edith and the remainder beneficiaries filed a complaint alleging that Philip breached his fiduciary duties and took excessive fees.

Law: In general, a trustee must administer a trust in the best interests of the beneficiary. In Virginia, and many other states, administering a trust in the best interests of the beneficiary requires a trustee to comply with the provisions of the Uniform Prudent Investor Act. The Uniform Prudent Investor Act provides that a trustee must invest and manage trust assets as a prudent investor would, "by considering the purposes, terms, distribution requirements and other circumstances of the trust." It also lists circumstances a Trustee should consider in applying that standard, including other resources of the beneficiary, needs for liquidity, and whether the trustee has special expertise. See Va. Code §§ 64.2-781 through 64.2-782.

The term “reasonable fees” is not defined in the Virginia Code, but the Supreme Court of Virginia has held that the determination of reasonable fees is based on the unique facts and circumstances of each case. See, e.g., Virginia Trust Co. v. Evans, 193 Va. 425, 433 (1952).

Holding: The Circuit Court of Virginia, First Judicial Circuit, Chesapeake City found that Philip’s aggressive investment strategy involving day trading and trading on the margin was in violation of the prudent investor rule.

The Court acknowledged that in some cases, aggressive investment strategies like day trading and margin trading might be warranted and are not a per se breach of the prudent investor standard. For example, a trustee might reasonably borrow money on margin where it is necessary to provide funds to the beneficiary, where the trustee has considered other possible sources of funds for the beneficiary, or if the market has dropped precipitously and the trustee does not wish to sell stock to meet that need. However, the Court found in this case there was no reason for Philip to engage in this risky investment activity other than to generate his own fees, and he was “betting someone else’s funds.”

The Court determined losses for the breach of fiduciary duty by measuring the trust’s total losses against the financial benchmarks presented by the expert witness of the beneficiaries. The Court imposed damages in the amount of $1,382,653.

Additionally, the Court found that Philip’s fees were excessive and unreasonable. The Court did not find Philip’s argument that his fees were based on a fee schedule published by his prior law firm persuasive, in part because the fees Philip charged after leaving the law firm were dramatically more than the amount charged when he was at the law firm. Looking to executor’s fees as an example, the Court stated that 5% of the total trust value might be considered reasonable, depending on the level of work necessary.

In this case, the Court found that Philip was managing “plain vanilla trusts,” so there was no reason for him to take the fees that he did, and that any additional work that would have justified the higher fees were a result of his own misbehavior in engaging in risky investment activity. The Court found that out of $1,057,000 Philip took in fees, only $286,722.15 were reasonable. The difference of $770,471.33 was awarded to the beneficiaries.

Practice Point: Although aggressive investment strategies may be warranted in some limited scenarios, a trustee should be mindful to comply with the prudent investor standard. Where a trust agreement does not define “reasonable fees”, a trustee should be careful that the fees charged are actually reasonable in relation to the duties performed and should not assume that a published fee schedule is reasonable.

68. Bradley v. Shaffer, 535 S.W.3d 242 (Tex. App. 2017)

The transfer of a beneficial interest in trust property by a beneficiary was void because the trust contained a valid spendthrift provision, and the doctrine of after-acquired title is not applicable to a void transfer

Facts: Darell was the beneficiary of a fixed 1/8 interest in a trust. The trust held certain mineral interests in Taylor County, Texas. The trust was scheduled to terminate in June of 2013, but could be extended by the unanimous consent of all the beneficiaries. The trust contained a spendthrift provision that read, "[n]o Trustee nor beneficiary of this Trust shall have any right or power to anticipate, pledge, assign, sell, transfer, alienate or encumber his or her interest in the Trust in any way; nor shall any such interest in any manner be liable for or subject to the debts, liabilities, or obligations of such Trustee or beneficiary or claims of any sort against such Trustee or beneficiary."

Between March and June of 2013, the beneficiaries agreed to extend the trust. In 2006, before the trust was extended, Darell executed a mineral deed in favor of Terry Bradley. The mineral deed contained language referring to Darell's beneficial interest in the trust and conveying that interest, as well as any mineral interest held in the trust that he might acquire in the future to Terry.

Before June 2013, the Trustees and one of the other beneficiaries (Darell's sister, Darlene) filed a motion seeking a judgment declaring the deed from Darell to Terry invalid because (1) Darell did not have any title in the mineral interest to convey because the title was held by the trust and not by Darell; and (2) Darell had no authority to convey any beneficial interest in the mineral interest because of the trust's spendthrift provision.

Terry's response argued that (a) the trust was always invalid because the extension provision violated the rule against perpetuities and therefore Darell did have title to the minerals at the time of conveyance; and (b) even if the trust was invalid at the time of the conveyance, the extension of the trust was invalid under the rule against perpetuities and the trust therefore terminated in June 2013, at which point Darell's mineral interest passed to Terry pursuant to the doctrine of after-acquired title. Terry did not address the spendthrift trust provisions.

The trial court ruled in favor of the Trustees and entered a final judgement declaring Darell's deed to Terry void. Terry appealed.

Law: Spendthrift trusts prohibit a beneficiary from anticipating or assigning his interest in or income from the trust, and are permitted by the Texas Trust Code. See Tex Prop. Code § 112.035. The doctrine of after-acquired titled provides that if the seller conveys title to a property to a buyer, a subsequently acquired interest in that property by the seller is automatically passed through to the buyer. The doctrine of after-acquired title does not apply to void transfers.

Holding: On appeal, the Court of Appeals of Texas, Eastland, affirmed the lower court's judgment and found the conveyances to Terry void. The Court held that the initial trust was valid, and rejected the challenge to the trust based on the rule against perpetuities. Further, because the Trust contained spendthrift language, Darell's conveyance to Terry could not become effective even upon the eventual termination of the trust. The Court rejected Terry's argument that he should acquire legal title upon the termination of the trust based on the doctrine of after-acquired title, because the doctrine of after-acquired title does not apply to transfers that were void from the outset.

Practice Point: This case underscores the far-reaching effects of spendthrift protection of a beneficiary's interest. If a trust contains a spendthrift provision, a beneficiary cannot transfer his or her interest in the trust or to any of its underlying assets. Conversely, if a beneficiary attempts to or is forced by a creditor to convey an interest in a trust containing a valid spendthrift provision, the trustee can void the transfer. Third parties dealing with a beneficiary should be mindful of the potential limitations and restrictions imposed by a spendthrift clause.

69. Hodges v. Johnson, 2017 WL 6347941 (N.H. 2017)

The Supreme Court of New Hampshire affirmed an order declaring a trust decanting void ab initio and removed the trustees for breach of duty of impartiality

Facts: David Hodges created two irrevocable trusts to hold stock in a family business, with his attorney, William Saturley, and Alan Johnson, an employee of the family business, as trustees. The trusts' beneficiaries were Hodges' wife, Joanne, his three children, and his two step-children.

The trusts provided for discretionary distributions to each of the beneficiaries during Hodges' lifetime. After his death, Joanne was named the primary beneficiary. Following Joanne's death, the trustee was to divide the trust into five separate trusts for each of Hodges' children and step-children. The trustee of each separate trust had discretionary power to distribute the net income and principal to the child and his or her descendants.

The trusts also included provisions specifically related to the family business. Each trust instrument established a "committee of business advisors", chosen by Hodges, with exclusive authority to make decisions for the family business after Hodges' death. Hodges funded the trusts with non-voting stock in various entities.

In 2009, Hodges retained attorney Joseph McDonald to assist with his estate planning. Hodges stated he wished to revoke the gifts to his step-children. McDonald advised Hodges that, although the trusts were irrevocable, the trustees could decant to new trusts, of which the step-children would not be beneficiaries. McDonald also offered to serve as the trustee who would accomplish the decanting.

Over the next few years, McDonald decanted the trust three times. First, in 2010, Johnson resigned as trustee in favor of McDonald. McDonald decanted both trusts, reappointed Johnson as trustee, and resigned. The decanted trusts specifically excluded Hodges' step-children as beneficiaries of the trusts.

Second, in 2012, McDonald was appointed as trustee and decanted the trusts to exclude Hodges' biological son, David Hodges Jr. Again, to accomplish this, Johnson resigned as trustee in favor of McDonald, and McDonald decanted the trusts to new trusts that excluded Hodges Jr. and the step-children. McDonald then resigned in favor of Johnson.

Third, and lastly, in 2013, McDonald was appointed as trustee and decanted the trusts for a third time in order to exclude Joanne. Once again, after the decanting, McDonald resigned in favor of Johnson.

In April 2014, Hodges Jr. and the step-children filed a petition to invalidate the decantings and to remove Johnson and Saturley as trustees, alleging a breach of the duty of impartiality. McDonald admitted he did not consider the excluded beneficiaries' interests when he decanted the trusts, but he maintained that he was not required to do so.

The trial court agreed the trustees had breached the duty of impartiality. Therefore, it declared the decantings void ab initio and removed Johnson and Saturley as trustees. Johnson, Saturley, and McDonald appealed.

Law: The duty of impartiality does not require a trustee to treat beneficiaries equally. For example, a trustee may make unequal distributions among beneficiaries, or eliminate a beneficiary's non-vested interest through decanting, if the trustee treats the beneficiaries equitably in light of the trust's terms and purposes. However, a trustee may not abuse its discretion in favoring certain beneficiaries over others.

Analysis: The Supreme Court of New Hampshire affirmed the trial court's order declaring the decanting void ab initio and removing Saturley and Johnson as trustees. The Court noted McDonald's admission that he did not consider the excluded beneficiaries' interests when he decanted the trusts. The Court found that supporting the five named beneficiaries was a primary purpose of the trust. Therefore, McDonald abused his discretion by eliminating the beneficiaries without considering their interests or other alternatives to promote the effective administration of the trusts.

The Court also rejected the trustees' argument that the decantings were necessary to protect the family business from intra-family conflict. The Court noted that the committee of business advisors had sole authority to manage the business, and that Hodges had the power to remove and replace committee members. The Court also observed that the trusts held only non-voting stock in the business. Therefore, the Court found that the beneficiaries' interests in the trusts did not threaten the family business.

Finally, the Court affirmed the trial court's removal of Johnson and Saturley as trustees. The Court noted its power to remove a trustee who has committed a serious breach of trust. The Court held that the trial court could have reasonably concluded that McDonald's decantings were a serious breach of trust.

Practice Point: State law generally does not require trustees to treat beneficiaries equally. However, a trustee must always act in good faith in accordance with the trust's terms and purposes, and must treat the beneficiaries equitably, based on the terms of the trust. A trustee should consider all purposes of a trust, including the interests of the beneficiaries, before making key decisions involving a trust, such as decanting. Moreover, the trustee should document that he, she or it considered those factors.

70. Matter of Sinzheimer, 2017 N.Y. Slip Op. 31379(U) (Surr. Ct. New York Cnty.)

Corporate trustee removed under the terms of the trust was not required to deliver the trust assets to individual co-trustee when a successor corporate trustee had not been appointed

Facts: Ronald and Marsha Sinzheimer created an irrevocable trust under agreement dated as of January 27, 1997. The trust terms provided for discretionary income and principal payments to Marsha for her lifetime, then directed the remaining trust assets to another trust under the trust agreement.

The trust agreement provided for the removal and appointment of successor trustees. The trust agreement stated that, before Ronald's death, the trustee "may" appoint a bank or trust company as co-trustee of the trust. Upon Ronald's death, however, the trust agreement stated that the individual trustee "shall" appoint a bank or trust company as co-trustee. Furthermore, the trust agreement stated that, if the individual trustee removes a corporate trustee after Ronald's death, the individual trustee "shall" appoint a successor corporate trustee.

Ronald died in 1998. After Ronald's death, the individual trustee appointed Merrill Lynch Trust Company ("Merrill Lynch") as corporate co-trustee. The individual trustee later removed Merrill Lynch as corporate co-trustee and resigned his own trusteeship in favor of Ronald and Marsha's son, Andrew. The individual trustee did not appoint a successor corporate co-trustee.

After Andrew accepted fiduciary duties, he and Marsha requested that Merrill Lynch distribute all of the trust assets to Marsha outright. Merrill Lynch asked for Marsha's tax returns and budgets in order to evaluate the request. Marsha refused. Instead, Andrew asserted that he was not required to appoint a successor corporate co-trustee, and demanded that Merrill Lynch deliver the trust assets to him as sole trustee of the trust. Andrew also announced that he intended to exercise his discretion as trustee to distribute the trust assets to Marsha outright. Merrill Lynch refused to transfer the trust assets to Andrew.

Andrew and Marsha filed a petition in the New York Surrogate's Court to remove Merrill Lynch as corporate co-trustee and compel it to transfer the trust assets to Andrew as sole trustee of the trust. Alternatively, they sought damages equal to the trust assets. Andrew and Marsha also argued Merrill Lynch committed civil conversion of the trust assets and sought $400,000 in punitive damages.

In response, Merrill Lynch petitioned the Court for an order directing Andrew to appoint a successor corporate co-trustee or alternatively authorizing Merrill Lynch to transfer the trust assets to Andrew as sole trustee.

Law: A court will give full force and effect to the plain language of a trust unless the terms are ambiguous. A custodian of property may retain the property until the owner proves his or her right to the property.

Analysis: The Surrogate's Court for New York County held that the trust terms clearly required Andrew to appoint a successor corporate co-trustee. Analyzing the trust terms, the Court observed that, before Ronald's death, the individual trustee "may" appoint a corporate fiduciary, but the trust terms stated that a corporate fiduciary "shall" be appointed upon Ronald's death. The Court also noted that, if the individual trustee removed a corporate co-trustee, the individual trustee "shall" appoint a successor co-trustee. Therefore, the Court denied Andrew and Marsha's petition.

The Court also rejected Andrew and Marsha's claim for conversion and punitive damages. Merrill Lynch did not assert title to the trust assets. Instead, it only requested that Andrew demonstrate his right to the property. Andrew could not demonstrate that right, because the trust terms did not allow him to serve as sole trustee. The Court also found Merrill Lynch's petition, filed four months after Andrew refused to appoint a successor corporate co-trustee, was filed expeditiously.

Practice Point: A removed trustee is generally required to transfer expeditiously the trust assets to the successor trustee. However, a removed trustee may retain fiduciary duties under the trust terms until a successor trustee is appointed. When the remaining trustee refuses to comply with the trust terms, or intends to take an action that may violate the terms of the trust, it may be prudent for the removed trustee to petition for court instruction before acceding to the remaining trustee's demands. The petition should be filed expeditiously and explain how the proposed action would violate the trust terms.

In communications with co-trustees and beneficiaries, though, the removed trustee should be careful not to assert title to the trust property. Instead, the trustee should make clear it is retaining custody only until the successor trustee proves its right to the property.

71. IMO Ronald J. Mount 2012 Irrevocable Dynasty Trust U/A/D December 5, 2012, No. CV 12892-VCS, 2017 WL 4082886 (Del. Ch. Sept. 7, 2017)

Delaware Chancery Court holds that a trust instrument may allow a trust protector to act in a non-fiduciary capacity. Therefore, it dismissed a claim against a trust protector for breach of fiduciary duties

Facts: Ronald J. Mount created the Ronald J. Mount 2012 Irrevocable Dynasty Trust under agreement dated as of December 5, 2012. Ronald named his long-time attorney, Kevin Kilcullen, as trust protector of the dynasty trust, and provided that he was to act in a non-fiduciary capacity. After Ronald died in 2015, his wife, Rene, and two children, Heather and Ian, initiated several lawsuits in multiple jurisdictions over the distribution of Ronald's estate

On July 5, 2016, Rene, Heather, Ian, and Kevin (and others) entered into a global settlement agreement to resolve the various lawsuits. The settlement agreement purportedly resolved how the dynasty trust and Ronald's revocable trust would be funded and administered. First, the dynasty trust would be divided into two separate trusts, one trust for Heather, and one trust for Ian. Heather's trust would be funded with $10 million, less one-half of certain expenses and taxes, and the remaining dynasty trust assets would fund Ian's trust.

After the relevant courts approved the settlement agreement, Heather, Ian, and Kevin began to disagree over the trusts' liabilities. Kevin, as trust protector of the dynasty trust, argued that Ian was required to pay a $4.2 million debt owed by the revocable trust to the dynasty trust.

Ian acknowledged that the $4.2 million debt to the dynasty trust was valid. However, he claimed that the debt was offset by a $6.9 million debt the dynasty trust owed to the revocable trust. Therefore, Ian argued the debts should partially offset, and in fact, the dynasty trust owed $1.4 million to the revocable trust.

When negotiations failed, Kevin filed a petition for instruction in the Delaware Court of Chancery. Ian filed counterclaims against Heather and Kevin alleging that Kevin had breached his fiduciary duties, notwithstanding the terms of the trust. Heather and Kevin filed separate motions to dismiss Ian's counterclaims.

Law: Under Delaware law, a grantor may allow an advisor, including a trust protector, to serve in a non-fiduciary capacity.

Analysis: The Delaware Court of Chancery dismissed Ian's breach of fiduciary duty claim against Kevin. The Court cited the terms of the dynasty trust, which stated that the trust protector did not act in a fiduciary capacity. The Delaware Code expressly allows grantors to provide that a trust protector serve in a non-fiduciary capacity.

The Court also rejected Ian's argument that the trust protector was a fiduciary despite the terms of the dynasty trust. Ian first argued that Kevin acted in a fiduciary capacity because Kevin also served on the trust's investment committee, through which he owed fiduciary duties. The Court noted that none of Kevin's alleged breaches arose in his capacity as an investment committee member. Therefore, the Court rejected Ian's argument.

Ian also argued that Kevin's expansive powers as trust protector imputed fiduciary duties upon him. Again, the Court rejected Ian's argument. Ian did not cite any statutes or case law to support his position; instead, he relied on law review articles questioning statutes that allow trust protectors to serve in a non-fiduciary capacity. In light of the clear terms of the trust and the statute, the Court rejected this argument as well.

Practice Point: State law may allow grantors to decide whether a trust protector will serve in a fiduciary or non-fiduciary capacity. In those jurisdictions, when the terms of the trust are clear, courts will give effect to trust terms even if the trust protector possesses expansive powers. Advisors should discuss with clients the benefits and drawbacks of allowing an advisor to serve with or without fiduciary duties in light of the client's goals.

72. Laborers' Pension Fund v. Miscevic, No. 17-2022 (7th Cir. Jan. 29, 2018)

ERISA does not preempt the Illinois slayer statute, and the Illinois slayer statute applies where the deceased was killed by an individual found not guilty by reason of insanity

Facts: Evidence produced at her criminal trial showed that Anka Miscevic killed her husband, Zeljko Miscevic, in January 2014; however, she was found not guilty by reason of insanity. Despite the finding that she was responsible for her husband's death, Anka then claimed she was entitled to her deceased husband's pension plan, which was governed by federal ERISA law. A claim was also made on behalf of their minor son for the benefits. Their minor son was awarded the benefits from the pension plan. Anka appealed.

Law: Illinois has a "slayer statute," which provides that "a person who intentionally and unjustifiably causes the death of another shall not receive any property, benefit, or other interest by reason of the death." However, neither federal ERISA law nor the pension's governing documents contains an express slayer provision; therefore, if federal law governs, the named beneficiary would receive the assets, despite the operation of a slayer statute under state law.

Holding: On appeal, the Court of Appeals for the Seventh Circuit upheld the interpretation that a slayer is precluded from obtaining the benefits payable under the decedent's pension plan even if they were found not guilty by reason of insanity. The Court reasoned that slayer statutes are traditionally an area of state regulation, and it rejected Anka's argument that Congress intended to preempt the slayer statutes through ERISA.ERISA was enacted after it was well established that an individual who kills another individual cannot benefit as a result of that death. Therefore, Congress could have clearly stated that it intended to change that result in certain situations, but their failure to explicitly state that intent results in a determination that it was not their intent.

Further, the Court held that Illinois' statute that provides that "a person who intentionally and unjustifiably causes the death of another" is broad enough to encompass a situation where an individual is found not guilty by reason of insanity. They deferred to state law decisions to interpret the statute. Anka argued that the killing was justifiable because she was found not guilty. The Court rejected this argument on the grounds that an insanity defense is an "excuse" defense, not a "justification" defense. The decision rests on lower court decisions interpreting the statute, and therefore the Court does acknowledge that the interpretation may be different in other states.

Practice Point: It is important to remember that federal statutes or regulations may be affected by state statutes. Lawyers should be mindful of other statutes that may change the outcome in particular situations.

73. Metropolitan Life Ins., Co. v. Teixeira, Civ. No. 16.07486 (D.N.J. 2017)

Interpleader protection does not extend to counterclaims that are not claims to the interpleaded funds

Facts: John J. Teixeira owned a life insurance policy on himself. The policy provided that the beneficiary may be any person the owner chose, but changes must be made in writing on a form approved by the insurance company and filed with the insurance provider. Teixeira's initial beneficiary designation named his wife, Janet Teixeira, as the sole beneficiary. This designation was made by telephone in March 2003. In July of 2015, Teixeira called MetLife to change his beneficiary designation to Gabriela Ramirez.

John Teixeira died in April of 2016.His daughter, Karen Sarto, claimed the benefits from the policy on Janet Teixeira's behalf. Along with her claim, she submitted a death certificate and a copy of the order stating she is the guardian of her mother, and therefore is allowed to act on her behalf. Sarto learned of the attempted beneficiary change and asserted John was incompetent at the time of the purported change. In June 2016, Ramirez also submitted a claim for the proceeds of the policy.

MetLife attempted to assist the parties in settling their dispute, but that attempt was unsuccessful. MetLife then filed an action for interpleader, alleging that it cannot determine whether the decedent was competent at the time of the beneficiary change. MetLife was granted interpleader relief. However, the Court refused to relieve MetLife from any and all liability relating to the claims. MetLife appealed.

Law: An interpleader action cannot be used to dismiss an insurance provider from liability for claims that are not related to the interpleaded funds.

Holding: Interpleader is equitable relief that allows a party that holds property more than one person claims they are entitled to join those two competing claims in one action. It allows a party who admits they are liable to one party, but fears liability to multiple parties to submit the property or money at issue to the Court and withdraw from the proceedings while the claimants litigate their claims.

The Court held that MetLife was entitled to some protection because it cannot determine which claim is superior without opening itself to double liability. The determination of who is entitled to the insurance proceeds depends on capacity of the decedent, and MetLife is not in the position to make that determination.

The Court further held that here, however, there was a possibility for an independent counterclaim based on the negligence of MetLife in allowing the oral beneficiary change when the policy states that a beneficiary change must be submitted in writing on an approved form. Therefore, there was a potential claim that is outside the scope of interpleader, and the Court concluded that MetLife cannot use impleader to relieve itself of liability for counterclaims that are not claims to the interpleaded funds.

Practice Point: Custodians or third parties can often find themselves in the middle of a dispute regarding the proper recipients of funds upon a person's death or similar situations. In such a case, interpleader can offer protection to that third party. However, interpleader actions that are granted do not protect parties like the insurance company from all liability, but rather they are only protected from liability as it relates to the interpleaded funds.

74. Harvey ex rel. Gladden v. Cumberland Tr. & Inv. Co., 532 S.W.3d 243 (Tenn. 2017)

Trustee had authority to enter into predispute arbitration agreement with financial advisor, and outcome of arbitration bound beneficiaries

Facts: Alexis Breanne Gladden was the minor beneficiary of a trust ("Alexis' Trust") created in 2001 and initially funded with $2,600,000. Alexis had suffered severe injuries after a stay in the hospital as an infant, and the proceeds of medical malpractice settlements constituted the entirety of her trust's corpus.

Cumberland Trust and Investment Company ("Cumberland") became sole trustee of Alexis' Trust in 2004. Five years later, Cumberland executed an account service agreement (the "Account Agreement") with Wonderlich Securities, Inc. ("Wonderlich") and Wonderlich-employee Albert M. Alexander, Jr. ("Alexander"), each of whom had provided investment management services to the trust for a number of years. The Account Agreement, which contained a predispute arbitration clause, was signed by Alexander, Cumberland, and Wonderlich, but not by Alexis or her representatives.

In 2011, Alexis' maternal grandfather, Wade Harvey, Sr. ("Harvey") succeeded Alexis' mother as Alexis' guardian. Shortly after his appointment, Harvey realized that the value of Alexis' Trust had fallen to less than $200,000.He then brought suit against Cumberland, Wonderlich, and Alexander for breach of fiduciary and contractual duties. The defendants moved to compel arbitration of those claims, and the trial court granted that motion to compel arbitration.

The Supreme Court of Tennessee agreed to review an interlocutory appeal of the trial court's order compelling arbitration of Harvey's claims. The Court of Appeals reversed. The defendants appealed.

Law: The Tennessee Uniform Trust Code (the "TUTC") gives trustees broad authority to select the commercial means by which they fulfill their fiduciary duties. Specifically, the TUTC permits trustees to enter into predispute arbitration agreements, so long as such agreements are not explicitly prohibited by the terms of the relevant trust instrument.

Holding: On appeal, the Supreme Court sided with the trial court, and compelled arbitration of Harvey's claims.

Alexis' trust instrument did not specifically prohibit Cumberland from entering into predispute arbitration agreements. As a result, Cumberland was impliedly authorized by the TUTC and the trust instrument to enter into such agreements. Further, Alexis was bound by the provisions of the Account Agreement insofar as she was a third-party beneficiary seeking to enforce rights under its terms.

The Court returned the case to the trial court for a determination of which of Harvey's claims sought to enforce the terms of the Account Agreement and were thus subject to its predispute arbitration provisions.

Practice Point: Under the laws of Tennessee, and now, perhaps, of other Uniform Trust Code jurisdictions, corporate fiduciaries have broad authority to enter into predispute arbitration agreements absent specific language prohibiting such contracts in the relevant trust instrument. Additionally, predispute arbitration provisions might bind not only a given contract's signatories, but also trust beneficiaries who seek to enforce duties created by the contract. Despite the potentially broad reach of this Court's reasoning, the Harvey decision is narrow in at least one important way. In footnote 34 of the Court's decision, the Court left open the possibility that factual situations could arise in which entering into a predispute arbitration agreement could violate a trustee's fiduciary duties. Arbitration clauses are, therefore, neither automatically prohibited nor necessarily permitted. Nevertheless, this case continues courts' enforcement of arbitration clauses in the context of claims for breach of fiduciary duty.

OTHER ITEMS OF INTEREST

75. Berkenfeld v. Lenet, _______ F.Supp.3d ________ (D. Md. 2018)

Broker not liable for annuity beneficiaries taking lump sum distributions

This case was before the court on a motion for summary judgment by the defendants Claire Blumberg passed away in February 2014 at which time she owned annuities issued by Lincoln Financial and Commonwealth/Scudder. When Blumberg died, her daughters and grandson were the beneficiaries of the annuities and each elected a lump sum distribution from the annuities. Each also elected not to have federal income tax withheld from their lump sum distributions. If the daughters and grandson had elected different distribution options, they could have avoided in excess of $200,000 in overall income tax liabilities. They alleged that they elected lump sum distributions because Lenet, an advisor at Morgan Stanley, advised them that the lump sum distribution was the only distribution option. The daughters and grandson sued Morgan Stanley and Lenet in Maryland state court for negligence and breach of fiduciary duty. The defendants remanded the case to federal court. The federal court ruled in favor of the financial advisor and Lenet.

According to the court, no contract or agreement existed between the parties obligating Lenet or Morgan Stanley to give tax advice or an opinion concerning plaintiffs' available distribution options. The plaintiffs also stated that Lenet advised them to seek independent tax advice concerning their distribution options. The plaintiffs did not seek advice despite having financial advisors and tax experts at their disposal.

Each plaintiff also signed a statement in electing a lump sum disbursement for each annuity which expressly notified them of all available distributions option. Plaintiffs additionally elected not to have federal income tax withheld from their lump sum distributions despite having been warned in writing, "if you opt out of our tax withholding, you are still liable for applicable taxes on your distribution….you may want to discuss your withholding election with a qualified tax advisor."

The court found that the requirements for summary judgment were met. The party seeking summary judgment must bear the initial burden of demonstrating the absence of a genuine dispute of material fact. In reviewing a motion for summary judgment, the court must take all facts and inferences in the light most favorable to the non-moving party.

The court first examined the claims of negligence against Lenet and Morgan Stanley to see whether the defendant owed a duty to the plaintiffs, whether the defendant breached that duty, whether a causal relationship existed between the breach and the harm plaintiffs suffered, and the amount of damages.

The court stated that Lenet owed a duty of care to the plaintiffs. In addition, sufficient evidence existed to establish Lenet's breach because plaintiffs testified that Lenet erroneously advised that the lump sum distributions were the only disbursement option. Also, Lenet's advice did not conform to the standard of care that was owed to the plaintiffs. It was clear that professional standards of care required Lenet to research plaintiffs' disbursement options and advise them accordingly. As a result, Lenet's erroneous advice was negligent.

The evidence, construed most favorably to plaintiffs, also established causation. Plaintiffs showed that, but for Lenet's advice, they would not have chosen the lump sum distribution option. It was also forseeable that plaintiffs would rely on the advice of a trusted financial advisor, the result of which was greater tax liability than that associated with the other distribution options. In addition, plaintiffs established a *prima facie* case of negligence against Lenet directly and vicariously as to Morgan Stanley. However, summary judgment was nonetheless warranted because plaintiffs was contributorily negligent.

As the court put it, this case is one in which no room for a difference of opinion exists as to the contributory negligence of the plaintiffs. Two plaintiffs had years of prior experience with annuities similar to the Lincoln and Commonwealth Scudder annuities. It was also undisputed that plaintiffs failed to exercise ordinary care to make prudent investment choices after Blumberg passed away. Despite Lenet expressly telling plaintiffs to obtain independent tax advice before electing a lump sum distribution, plaintiffs never did so even those they had professional advisors. Finally, the election form which plaintiffs used to select a lump sum distribution clearly identified all other distribution alternatives and required that plaintiffs select one. The Lincoln forms also stated, "Instructions, important information, please read carefully and completely". Defendant's motion for summary judgment was also granted on the breach of fiduciary duty count. While a breach of fiduciary duty may support a negligence or breach of contract claim it is not a stand-alone cause of action under Maryland law.

76. Estate of Rubin A. Meyers v. Commissioner, T.C. Memo 2017-11

Recipients of assets received by means other than a will or state law governing the distribution of a deceased person's property could be liable for unpaid estate taxes ten years later

Rubin A. Meyers died in November 2005. On February 15, 2007, the executor filed a federal estate tax return and began making installment payments pursuant to Section 6166. In 2007 through 2013, the estate made the required payments. In 2014, the estate became delinquent. A revenue officer was assigned to collect the delinquent payments. On October 7, 2014, the revenue officer filed the Notes of the Federal Tax Lien ("NFTL") and shortly thereafter notified the executor that the NFTL had been filed and of this right to a Collection Due Process ("CDP") hearing. On October 29, 2014, the revenue officer notified the executor of the IRS's intent to levy to collect the delinquent tax and of his right to a CDP hearing. The unpaid liability for estate tax, interest, and penalties was then $380,000. The estate timely submitted a request for a CDP hearing, asking for an offer in compromise and stating that he was unable to pay the balance due and requesting withdrawal of the NFTL.

After the submission of the request form, the revenue officer made an inappropriate contact with the settlement officer assigned to conduct the CDP hearing. As a result, the case was assigned to another settlement officer. A face to face meeting was set for April 9, 2015. Prior to the hearing, the executor provided the settlement officer with the financial information but did not submit a completed offer in compromise.

At the hearing, the executor stated that paying the delinquent estate tax liability from probate assets would require the sale of family farm lands that would be difficult to liquidate. He suggested that the IRS take action to collect the delinquent liability from third parties that had received cash or liquid non-probate assets. He also represented that he had no access to non-probate assets as a source of funds to pay the estate tax liability. As a result of the hearing, the settlement officer determined that the estate did not qualify for non-collectible status or hardship, but that the IRS could pursue collection of the estate tax from non-probate assets. The NFTL was kept in place because the petitioner had not provided sufficient justification for withdrawal.

The special estate tax lien against the family farm expired on November 15, 2015, ten years after decedent's death. The IRS had not taken any action to attach or otherwise collect the estate tax liability with respect to the non-probate assets. The court held that while the ten year period for imposing personal liability could still be open after expiration of the ten year special estate tax lien against the family farm and the probate estate. Although the lien begins to run as of the date of death, the ten year collection period runs from the date of assessment.

77. Estate of Marion Levine v. Commissioner, Docket No. 13370-13 (Tax Court October 26, 2017)

Estate granted protective order limiting scope of IRS subpoena

In a case scheduled for trial in November 2017, the estate moved for a protective order on October 18, 2017 to limit the scope of a subpoena duces tecum that the IRS served in September on Shane N. Swanson and his firm Stinson Leonard Street, LLP, which was one of the firms representing the estate. It asked for all documents that Swanson and Stinson Leonard had in their files for the decedent and her estate for the period from January 1, 2007 until July 1, 2017. The representatives of the estate and trustees of Levine's trust stated that anything after April 19, 2013, which was the date that the IRS issued the notice of deficiency, was work product, and it would be unduly burdensome to prepare a privilege log so close to trial for what would inevitably prove undiscoverable material.

Swanson was a key player in the case. He created Marion Levine's estate planning and prepared the estate tax return at issue. Swanson filed the estate tax return in April 2010 and he responded on behalf of the estate during the audit that lead to the notice of deficiency in April 2013. The IRS now sought to look at the files all the way through the middle of 2017. The court first noted that the work product privilege exists to prevent "unwarranted inquiries into the files and the mental impressions of an attorney" because "it is essential that a lawyer work with a certain degree of privacy." The privilege specifically limits the discovery of documents prepared "in anticipation of litigation." Courts previously held that documents prepared during audit and before the IRS issues a notice of deficiency can be created "in anticipation of litigation", Bernardo v. Commissioner, 104 T.C. 677 (1995). Any documents that Swanson and his firm produced after the estate retained him specifically for the litigation likely fit within the definition of work product. Previously, the Tax Court had held that raising a good faith defense could waive the attorney-client privilege, but the IRS cited no authority saying that raising the defense waives the doctrine with respect to documents produced after the litigation begins. The court consequently limited the subpoena to the period beginning January 1, 2007 and ending April 19, 2013 which was prior to the issuance of the notice of deficiency.

78. Hawk, Billy F., Jr. GST Non-Exempt Marital Trust, et al. v. Commissioner, T.C. Memo 2017-217

Decedent's estate, two marital trusts, and decedent's widow were liable as transferees under Section 6901 and applicable state law for unpaid income taxes from the sale of a bowling alley

Billy F. Hawk, Jr. died in February 2000. At the time of his death, Mr. Hawk owned and managed two bowling alleys in Tennessee through Holiday Bowl, Inc. ("Holiday Bowl"). At the time of the transactions at issue in this case, the estate owned 81.25% of Holiday Bowl, including 100% of the voting stock. Mrs. Hawk owned the remaining 18.75%.

The IRS asserted that transferee liability for income taxes arose from a series of transactions in 2003 involving Holiday Bowl that occurred after Mr. Hawk's death. First, Holiday Bowl sold its primary assets, the two bowling alleys, to an unrelated third party. Next, Holiday Bowl distributed unimproved real property to the estate and Mrs. Hawk in a stock redemption. The same day as the redemption, the estate and Mrs. Hawk sold the remaining shares to an unrelated third party, MidCoast Investment Inc. ("Midcoast") and its related entities, which as the court put it, was a "familiar entity in recent transferee liability cases." MidCoast immediately resold the stock to yet another third party. The estate subsequently distributed the proceeds from the MidCoast transaction to the two marital trusts. The petitioner saved approximately $300,000 in tax by engaging in the MidCoast transaction. The tax savings represented an approximate 15% premium above Holiday Bowl's book value. The IRS sought to recover approximately $1.3 million in taxes and a penalty from petitioners.

The basic strategy in which MidCoast engaged was to leverage its profits by purchasing Holiday Bowl's cash at a discount based on its tax liability and then deferring the actual payment of tax since MidCoast had heavy expenses in the early months after a loan portfolio purchase. MidCoast has more cash available to purchase loans so it ends up making a greater profit in the end.

For transferee liability to be imposed under Section 6901(a) a court must determine whether:

1. The transferor is liable for the unpaid tax;

2. The petitioners are liable as transferees within the meaning of Section 6901; and

3. Petitioners are subject to substantive liability as transferees under applicable state law or state equity principles.

The court found that the petitioners should have known that MidCoast did not have a legitimate strategy to avoid or defer Holiday Bowl's 2003 income tax. Petitioners and their advisors knew that the IRS had identified intermediary transactions similar to the MidCoast transactions as listed transactions that the IRS considered abusive tax shelters and should have known that the IRS would scrutinize the MidCoast transaction, on that basis. This was discussed in Notice 2001-16, 2001-1 C.B. 730. In addition, the taxpayers did not obtain a tax opinion that analyzed the IRS's pronouncement in Notice 2001-16 on listed transactions. The court also noted that the petitioners knew that Holiday Bowl would not pay tax for 2003 and there is no distinction between the nonpayment of the income tax in 2003 and the advisor's characterization of MidCoast's stated tax strategy as a deferral of tax, as petitioners knew there was a likelihood that Holiday Bowl would be insolvent after 2003 and would exist as a shell.

The court then noted that for purposes of Section 6901, the term "transferee" includes a donee, heir, devisee, distributee, or shareholder of the dissolved corporation. The court held that the petitioners faced joint and several liability under Section 6901. It then held that the estate and nonexempt trust were liable for the accuracy related penalty asserted against Holiday Bowl. Finally, the court held that the nonexempt trust and the estate were liable for pre-notice interest. Because Mrs. Hawk and the exempt trust did not control the filing of the tax return, the tax payment, or the tax documentation, they were not held liable for pre notice interest.

79. United States v. Raelinn M. Spiekhout (In the Matter of Estate of Simmons), ___ F. Supp. 3d ___ (S.D. Ind. July 31, 2017)

Government's tax liens have priority

Frederick Allen Simmons died on June 5, 2014. Raelinn M. Spiekhout, the decedent's second wife, was the surviving spouse and personal representative of the estate. The principal asset of the estate was a residence in Zionsville, Indiana. Simmons's first wife was Deborah Scott. Simmons and Scott had one child, Erik Simmons, who was born in 1991. When Scott and Simmons divorced in 1998, the divorce decree provided in relevant part that Simmons would pay $1,274 per month in child support, $1,000 per month in maintenance, Erik's health insurance benefits, and any of Erik's uninsured healthcare costs. Simmons also agreed to hold Scott harmless from any and all encumbrances on the property and quitclaim. Scott qui claimed her interest in the property to Simmons.

Upon opening of the estate, a number of claims were filed, including claims by Scott for past due child support, alimony, medical expenses, insurance expenses, claims for unpaid wages and benefits, a claim for an alleged breach of lease, a claim for default of a promissory note, a claim by the State of Indiana for two tax warrants, and a claim by the Internal Revenue Service for unpaid federal income taxes totaling $591,406.

On March 16, 2015, Spiekhout filed a petition to approve the sale of the property for $282,000 but did not file a notice to trigger the 30-day removal period. The state court approved the sale on April 16, 2015. Spiekhout filed a petition to close the estate as insolvent showing that the estate anticipated having total distributable assets of only $266,872.70 as contrasted against $1,812,621.69 in claims.

On July 10, 2015, the state court issued an order closing the estate as insolvent. The distribution listed the federal tax lien as seventh in priority amount creditors. On July 14, 2015, the government moved the state court action to federal court, challenging the state court's disposition of the tax lien. Spiekhout then argued that the government's federal tax lien does not have priority over Spiekhout's claim for preserving the property, because compensation for services provided the estate are debts of the estate, rather than debts of the debtor. The government argued that it properly filed notice of its federal tax liens and those liens should prevail over Spiekhout's interests because Spiekhout was not a secured creditor. As a result, the court specifically concluded that the federal tax lien had priority regarding the proceeds of the estate.

80. Letter Ruling 201750004 (Issued September 12, 2017; Released December 15, 2017)

Subtrust is valid see-through trust

Decedent established a revocable living trust. Decedent died at age 61. Upon Decedent's death, the revocable trust became an irrevocable trust with Daughter as the sole beneficiary of the trust. A subtrust was established to hold all of the assets from Decedent's retirement accounts. Daughter was the sole beneficiary of the subtrust. At the time of her death, Decedent held one traditional individual retirement account, one Roth individual retirement account, and two annuity contracts under her former employer's Section 403(b) plan.

The taxpayer requested a ruling that the applicable distribution period for the retirement accounts held by Decedent was to be calculated based on the life expectancy of Daughter, the designated beneficiary of the subtrust. The Service noted that because the retirement accounts each listed the subtrust as the beneficiary, it must determine whether the requirements of a see-through trust had been met. The documentation provided showed that the trust was valid and irrevocable. The third requirement is that the beneficiary or beneficiaries be identifiable within the trust document. The Service found that the Daughter was identifiable in the subtrust and was the sole designated beneficiary of the retirement accounts.

The determination of whether the subtrust qualified as a see-through trust depended on whether the beneficiaries of the subtrust could be identified at the time of Decedent's death. The trust provided Daughter with a testamentary general power of appointment. This power of appointment generally applies to any accumulation of retirement account distributions that would accumulate in the subtrust. However, when the subtrust was read together with the trust, the subtrust required the trustee to pay to Daughter any and all funds in the subtrust that were drawn by the trustee including the minimum distributions during Daughter's lifetime. Consequently, there could be no accumulation of retirement account distributions in the subtrust for the benefit of any other beneficiary. As a result, all of the beneficiaries were identifiable and the required minimum distributions could be paid based on the life expectancy of Daughter as the sole designated beneficiary of the subtrust.

81. Letter Ruling 201805011 (Issued November 2, 2017; Released February 2, 2018)

IRS grants extension to waive family attribution rules

Taxpayer was a domestic individual who was treated as the owner of stock of a corporation held by a grantor trust. Members of Taxpayer's family also directly owned stock of the corporation or were treated as owning corporation stock held by separate trusts. On one date, all of Taxpayer's trust's corporation stock was redeemed for a combination of cash and promissory notes.

Taxpayer requested an extension of time to file the statement required by Treas. Reg. § 1.302-4(a) to waive the family attribution rules with respect to a redemption of the corporation's shares that is treated as a complete termination of a shareholder's interest in a corporation. Taxpayer intended to file the election, but for various reasons, the election was not filed. Under Section 318, an individual is considered to own stock owned directly or indirectly by or for his spouse, children, grandchildren, and parents (the "family attribution rules"). Section 302(c)(2) provides that Section 318 shall not apply in determining if the redemption is a complete termination of interest if:

1. Immediately after the distribution, the distributee had no interest in the corporation other than as a creditor;

2. The distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution; and

3. The distributee at such time and in such manner and the distributee notifies the secretary.

This notice must be filed on or with the distributee's first return for the taxable year in which the distribution occurs. The IRS found that under Treas. Reg. § 301.9100-3, relief could be granted. The information established that Taxpayer reasonably relied on a qualified tax professional who failed to make or advise Taxpayer to make a valid election and that the request for relief was filed before the failure to make the election was discovered by the Internal Revue Service. Taxpayer showed that it acted reasonably and in good faith, and that granting relief would not prejudice the interest of the government. Thus the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 had been satisfied, and the extension of time was granted.

82. United States v. Paulson __ F. Supp. 3d __ (S.D. Cal. 2018)

Court denies defendant's motion to stay proceedings pending decision of state court

Allen Paulson established a living trust in 1986. In 1988, Allen Paulson entered into an ante-nuptial agreement with Madeleine Pickens. The ante-nuptial agreement defined their respective separate property and established certain gifts for Madeleine in the event of Allen's death. Allen subsequently amended and restated the living trust several times in early 2000 prior to his death on July 19, 2000.

The living trust gave Madeleine the power to elect between receiving property under the anti-nuptial agreement or under the living trust but not both. The living trust also created a marital trust for Madeleine's benefit. Under the terms of the living trust, the marital trust was to receive a residence and all personal property located at the residence in Rancho Santa Fe, California. The living trust also gave Madeleine the right to receive a second residence located in Del Mar, California as well as the tangible property in that residence. The marital trust also was to receive 25 percent of the residue of the living trust. The living trust named Madeleine, Michael Paulson (Allen's son), and Edward White as the co-trustees of the marital trust.

At the time of Allen's death, all of Allen's assets were held in the living trust except his shares in the Gold River Hotel and Casino Corporation. The living trust assets included approximately $24,764,500 in real estate; $113,761,706 in stocks and bonds; $23,664,644 in cash and receivables, and $31,243,494 in miscellaneous assets. Accordingly, the estate assets totaled approximately $193,434,344. Michael Paulson, served as the executor of Allen's estate. Michael Paulson also became the co-trustee of the living trust, with Edward White until White's resignation on October 8, 2001. Thereafter, Nicholas V. Diaco acted as co-trustee of the living trust with Michael Paulson.

In April 2001, the estate requested an extension of time to file the Form 706 until October 19, 2001 and an extension of time to pay taxes until October 19, 2002. Both requests for extension were granted. On October 23, 2001, the IRS received the estate's Form 706 which was signed by Michael Paulson as co-executor of the estate. In completing the tax return, the estate elected to use the alternate evaluation date of January 19, 2001. The estate reported a total gross estate of $187,726,626, a net taxable estate of $9,234,172 and an estate tax liability of $4,459,051. On November 22, 2001, the IRS assessed the reported tax of $4,459,051. The estate elected to pay part of its taxes and defer the other portion under Section 6166. Accordingly, the estate paid $706,296 as the amount not qualified for deferral, leaving a deferral balance of $3,752,755 to be paid under the Section 6166 installment election. While the estate's tax return was under review, personal disputes arose between Michael, Madeleine, and other beneficiaries. In 2003, the parties reached a settlement which was approved by the California Probate Court. Under the 2003 settlement, Madeleine forewent property under both the ante-nuptial agreement and the living trust, instead choosing to receive direct distributions from the living trust. Madeleine received the Rancho Santa Fe residence, the Del Mar residence, and the stock in the Del Mar Country Club. These distributions were made directly to Madeleine as trustee of her separate property trust. During 2004, Michael, as trustee of the living trust, distributed $5,921,888 of trust assets to various individuals.

On January 16, 2005, the IRS issued a notice of deficiency to Michael as executor of the estate which proposed a $37,801,245 deficiency in estate tax. This was argued before the tax court and the tax court determined that the estate had $6,669,477 in additional estate tax which the estate elected to pay under Section 6166. During 2006, Michael distributed an additional $1,250,000 from the living trust. In March 2009, the probate court removed Michael Paulson as trustee for misconduct. At that point, two other children of Allen, Vikki Paulson and James Paulson were appointed as co-trustees. They reported that the living trust had assets worth $13,738,727. On May 7, 2010, in response to one or more missed installment payments, the IRS issued the estate a notice of final termination, stating that the extension of time for payment under Section 6166 no longer applied. On June 10, 2010, the probate court removed James Paulson as a co-trustee for breach of court orders. Accordingly, Vikki remained as the sole trustee of the living trust.

On August 5, 2010, the estate filed a petition in the tax court challenging the proposed termination of the Section 6166 installment payment election. On February 28, 2011, Crystal Christensen was appointed as co-trustee of the living trust. At this time, the living trust assets were worth approximately $8,802,034. In May 2011, the tax court entered a stipulated decision sustaining the IRS's decision to terminate the installment payment election. Between June 28, 2011 and July 7, 2011, the IRS reported notices of federal tax liens against the estate in the property records of San Diego and Los Angeles counties. On August 16, 2012, Vikki Paulson and Crystal Christensen, as successor trustees to the living trust, filed a petition for review of the estate's collection due process rights with the tax court. This was dismissed by the tax court on April 18, 2013 for lack of jurisdiction because Michael Paulson, who was the court-appointed executor at the time the petition was filed, did not sign the petition.

From approximately 2007 through 2013, several disputes arose between Michael, Vikki, Crystal Christensen, James, and other interested parties which were eventually settled on June 3, 2013. As a result of the 2013 settlement, Michael obtained the living trust's ownership interest in Supersonic Aerospace International LLC, the Gold River Hotel and Casino Corporation, and the Gold River Operation Corporation. As of July 10, 2015, the estate had an unpaid estate tax liability of $10,261,217. On September 16, 2015, the IRS filed a complaint seeking judgment against the estate for unpaid estate taxes and against, the defendants in either their representative or individual capacities or both for unpaid estate taxes.

As of September 16, 2015, there were several complaints against the trustees or executors for unpaid taxes and cross-claims between them. There were also several motions for summary judgment that were pending on the eve of decision in this matter.

Vikki and Crystal requested that the court stay the various motions for summary judgment while the California Probate Court heard their petition which was filed on February 13, 2018. The court noted that in determining when a stay is appropriate, it must weigh competing interest and maintain an even balance. In determining whether to grant the stay, courts considered three factors:

1. the possible damage which may result in granting the stay;

2. the hardship or inequity which a party may suffer in being required to go forward; and

3. the orderly course of justice measured in terms of the simplifying or complicating of issues, proof, and questions of law which could be expected result from a stay.

The court in looking at the request determined that the defendants would not suffer undue hardship if the action was not stayed. It then noted, that the government would be prejudiced if a stay were granted. It noted the defendants made this request nearly three years after the government first filed this action and provided no indication of when the probate court would resolve the issues. In addition, the probate petition would not simplify the issues before the court. Instead, because this case invoked the federal question, as well as issues that the federal court had been dealing with since 2015, staying the case would be "unconstructive". As a result, all three factors weighed against the defendants' motion to stay and the motion was denied.

83. Changes in state death taxes in 2018

Several states see changes in their state death taxes in 2018

Several states either made changes or saw changes in their state death taxes as a result of the doubling of the federal estate tax applicable exclusion amount under the 2017 Tax Act. In Hawaii, on June 7, 2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation.

Maine does not appear to have picked up the amendments made in the 2017 federal tax reform act. For estates of decedents dying on or after January 1, 2016, the "Maine exclusion amount "means the basic exclusion amount determined for the calendar year in accordance with Section 2010(c)(3) of the "Code." 36 M.R.S. § 4102(5). However, Maine's tax law defines "Code" as the United States Internal Revenue Code of 1986 and any amendments to that Code as of December 31, 2016. This arguably means that the Maine exemption equals the exemption prior to the changes made by the 2017 Tax Act.

In Maryland, on April 5, 2018, HB 0308 became law. The new law provides that for 2019 and thereafter, the Maryland threshold will be capped at the fixed amount of $5 million rather than being equal to the inflation-adjusted federal exemption as provided under prior law. The new law also provides for the portability of the unused predeceased spouse's Maryland exemption amount to the surviving spouse beginning in 2019.

New York, which was scheduled to see its exemption equal the federal exemption on January 1, 2019, will not because of the wording of its legislation. As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount **prior** to the 2017 Tax Act which is $5,000,000 adjusted for inflation. The maximum rate of tax will continue to be 16%.

The District of Columbia is trying to decouple it exemption from the federal exemption. DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018. This proposal would cut the DC threshold to $5.6 million retroactive to January 1, 2018. The threshold would be indexed for inflation. While a majority of the members of the DC City Council support the proposal, the chair of the Council's Finance Committee does not and the proposal is currently held up in committee.

Other states saw changes unrelated to the 2017 Tax Act. In Connecticut, on October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the exemption for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the amount of the federal estate and gift tax exemption in 2020. Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).

Delaware in 2017 repealed its state death tax effective January 1, 2018.

84. 2018 State Death Tax Chart (as of July 9, 2018)

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.		

	Type of Tax	**Effect of EGTRRA on Pick-up Tax and Size of Gross Estate**	**Legislation Affecting State Death Tax**	**2018 State Death Tax Threshold**
Colorado	None	Tax is tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102.		
Connecticut	Separate Estate Tax	As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST § 12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011.	On October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the exemption for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the federal estate and gift tax exemption in 2020. Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).	$2,600,000

	Type of Tax	**Effect of EGTRRA on Pick-up Tax and Size of Gross Estate**	**Legislation Affecting State Death Tax**	**2018 State Death Tax Threshold**
Delaware	None	On July 2, 2017, the Governor signed HB 16 which sunsets the Delaware Estate Tax on December 31, 2017.		
District of Columbia	Pick-up Only	As a result of 2015 legislation as modified in 2017, the threshold will match federal exemption as it is indexed for inflation beginning in 2018. DC CODE 47-3701(14) No separate state QTIP election.	DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018. This proposal would cut the DC threshold to $5.6 million retroactive to January 1, 2018. The threshold would be indexed for inflation. While a majority of the members of the DC City Council support the proposal, the chair of the Council's Finance Committee does not and the proposal is currently held up in committee.	$11,180,000
Florida	None	Tax is tied to federal state death tax credit.		

	Type of Tax	**Effect of EGTRRA on Pick-up Tax and Size of Gross Estate**	**Legislation Affecting State Death Tax**	**2018 State Death Tax Threshold**
		FL ST § 198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Effective July 1, 2014, the Georgia estate tax was repealed. See § 48-12-1.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§ 236D-3; 236D-2; 236D-B The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non US citizen.	On May 2, 2012, the Hawaii legislature passed HB2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012. On June 7, 2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation.	$5,600,000
Idaho	None	Tax is tied to federal state death tax credit.		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).		
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		$4,000,000
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001 which repealed Indiana's inheritance tax retroactively to January 1,	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			2013. This replaced Indiana's prior law enacted in 2012 which phased out Indiana's inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2. Iowa has a separate inheritance tax on transfers to others than lineal ascendants and descendants.		
Kansas	None	For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		a separate stand alone estate tax. KS ST § 79-15, 203		
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		
Louisiana	None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed,	Maine does not appear to have picked up the amendments made in the 2017 federal tax reform act. For estates of decedents dying on or after January 1, 2016, the “Maine exclusion amount “means the basic exclusion amount determined for the calendar year in accordance	$5,600,000 Estimated

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. On June 30, 2015, the Maine legislature overrode the Governor's veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the new law, the Maine Exemption is tagged to the federal exemption for decedents dying on or after January 1, 2016. The tax rates will be: 8% on the first $3 million above the Maine Exemption; 10% on the next $3 million above the Maine Exemption; and !2% on all amounts above $6 million above the Maine Exemption. The new legislation did not include portability as part of the Maine Estate Tax. For estates of decedents dying after December 31,	with Section 2010(c)(3) of the "Code." 36 M.R.S. § 4102(5). However, Maine's tax law defines "Code" as the United States Internal Revenue Code of 1986 and any amendments to that Code as of December 31, 2016.	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non-resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following: 1. Increases the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount.	On April 5, 2018, HB 0308 became law. The new law provides that for 2019 and thereafter, the Maryland threshold will be capped at the fixed amount of $5 million rather than being equal to the inflation-adjusted federal exemption as provided under prior law. The new law also provides for the portability of the unused predeceased spouse's	$4,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus eliminating a circular computation. 4. Permits a state QTIP election.	Maryland exemption amount to the surviving spouse beginning in 2019.	
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at		$1,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax is tied to federal state death tax credit. MI ST §§ 205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000,	On May 30, 2017, the governor signed the	$2,400,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	budget bill, H.F. No. 1 which increased the Minnesota estate tax exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases the exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 for 2020 and thereafter. A provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota was amended in 2014 to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			that own closely held businesses, farms, and cabins.	
Mississippi	None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT ST § 72-16-904; 72-16-905.		
Nebraska	County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST § 77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.		
New Jersey	Inheritance Tax	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST § 54:38-1 Pick-up tax imposed on estates exceeding federal	On October 14, Governor Christie signed Assembly Bill A-12 which was the tax bill accompanying the Assembly Bill A-10	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. The exemption will be increased to $2 million in 2017 and the pick-up tax, but the inheritance tax, will be eliminated as of January 1, 2018. The executor has the option of paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ ST § 54:38-1; approved on July 1, 2002. In Oberhand v. Director, Div. of Tax, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions. In Estate of Stevenson v. Director, 008300-07 (N.J.Tax 2-19-2008) the	which revised the funding for the state's Transportation Fund. Under this new law, the Pick-Up Tax will have a $2 million exemption in 2017 and will be eliminated as of January 1, 2018. The new law also eliminates the tax on New Jersey real and tangible property of a non-resident decedent. The repeal of the pick-up tax does not apply to the separate New Jersey inheritance tax.	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001. New Jersey allows a separate state QTIP election when a federal estate tax return is not filed and is not required to be filed. The New Jersey Administrative Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d)		
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX § 951. Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-	The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made	$5,250,000 April 1, 2017 through December 31, 2018)

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M. Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the	substantial changes to New York's estate tax. The New York estate tax exemption which was $1,000,000 through March 31, 2014 has been increased as follows: April 1, 2014 to March 31, 2015 -- $2,062,500 April 1, 2015 to March 31, 2016 -- $3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		sole reason for forming the S Corporation was to own assets.	amount **prior** to the 2017 Tax Act which is $5,000,000 adjusted for inflation. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available. On April 1, 2015, as part of 2015-2016 Executive	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			Budget, New York enacted changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the rate schedule only applied through March 31, 2015. New York then modified the three year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019. New York continues to not	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			permit portability for New York estates and no QTIP election is allowed.	
North Carolina	None		On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to January 1, 2013.	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state death tax credit. OK ST Title 68 § 804		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		$1,000,000
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit.		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1.1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax.	$1,537,656
South Carolina	None	Tax is tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	None	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203. Tennessee had a separate inheritance tax which was phased out as of January 1, 2016.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762 which phased out the Tennessee Inheritance Tax as of January 1, 2016. The Tennessee Inheritance Tax Exemption was increased to $1.25 million in 2013, $2 million in 2014, and $5 million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB2777 which repealed the Tennessee state gift tax retroactive to January 1, 2012.	
Texas	None	Tax was permanently repealed effective as of September 15, 2015 when		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		Chapter 211 of the Texas Tax Code was repealed. Prior to September 15, 2015, the tax was tied to the federal state death tax credit.		
Utah	None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.		$2,750,000
Virginia	None	Tax is tied to federal state death tax credit. VA ST §§ 58.1-901; 58.1-902.		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		The Virginia tax was repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, the Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005). In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A	On June 14, 2013, Governor Inslee signed HB 2075 which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax threshold for inflation.	$2,193,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a separate state QTIP election. WA ST §83.100.047.		
West Virginia	None	Tax is tied to federal state death tax credit. WV § 11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.		

Recent Developments

Charles D. Fox IV

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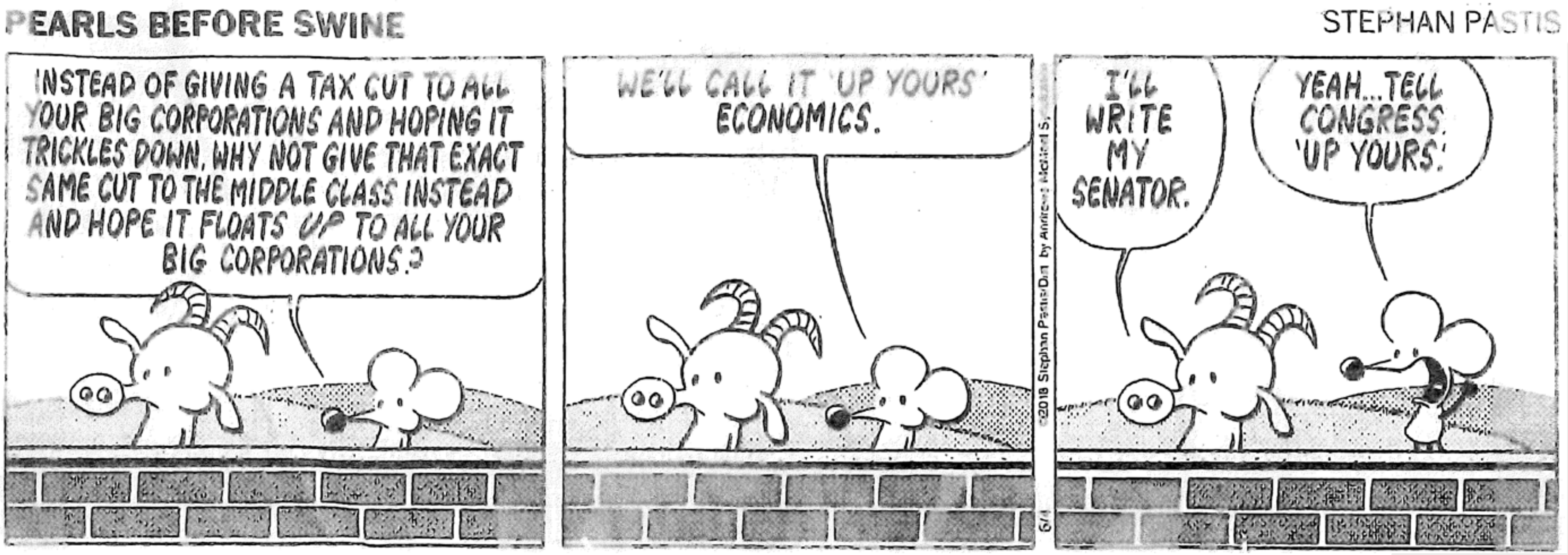
PART A

Confronting the Challenges of Tax Reform: What Happened to the Certainty of Death and Taxes?


PEARLS BEFORE SWINE
STEPHAN PASTIS
INSTEAD OF GIVING A TAX CUT TO ALL YOUR BIG CORPORATIONS AND HOPING IT TRICKLES DOWN, WHY NOT GIVE THAT EXACT SAME CUT TO THE MIDDLE CLASS INSTEAD AND HOPE IT FLOATS UP TO ALL YOUR BIG CORPORATIONS?
WE'LL CALL IT 'UP YOURS' ECONOMICS.
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6/4
I'LL WRITE MY SENATOR.
YEAH...TELL CONGRESS, 'UP YOURS.'

Why are these people smiling?

What is President Trump doing?

Introduction

- Enactment of 2017 Tax Act
  - Briefly called "Tax Cuts and Jobs Act" or "Reconciliation Act of 2017"
    - Official Title: "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"
  - Passed House on December 19, 2017 by a vote of 227-203
    - No Democrat voted for the Act and 13 Republicans voted against it
  - Senate parliamentarian determined that three provisions (including the name of the Act) were extraneous to reconciliation and were removed
  - Passed Senate by a party-line vote of 51-48 on December 20, 2017
  - Signed by the President on December 22, 2017

“LAFTRA”

“Lawyers, Accountants, Financial Professionals, and Trust Professionals Relief Act”

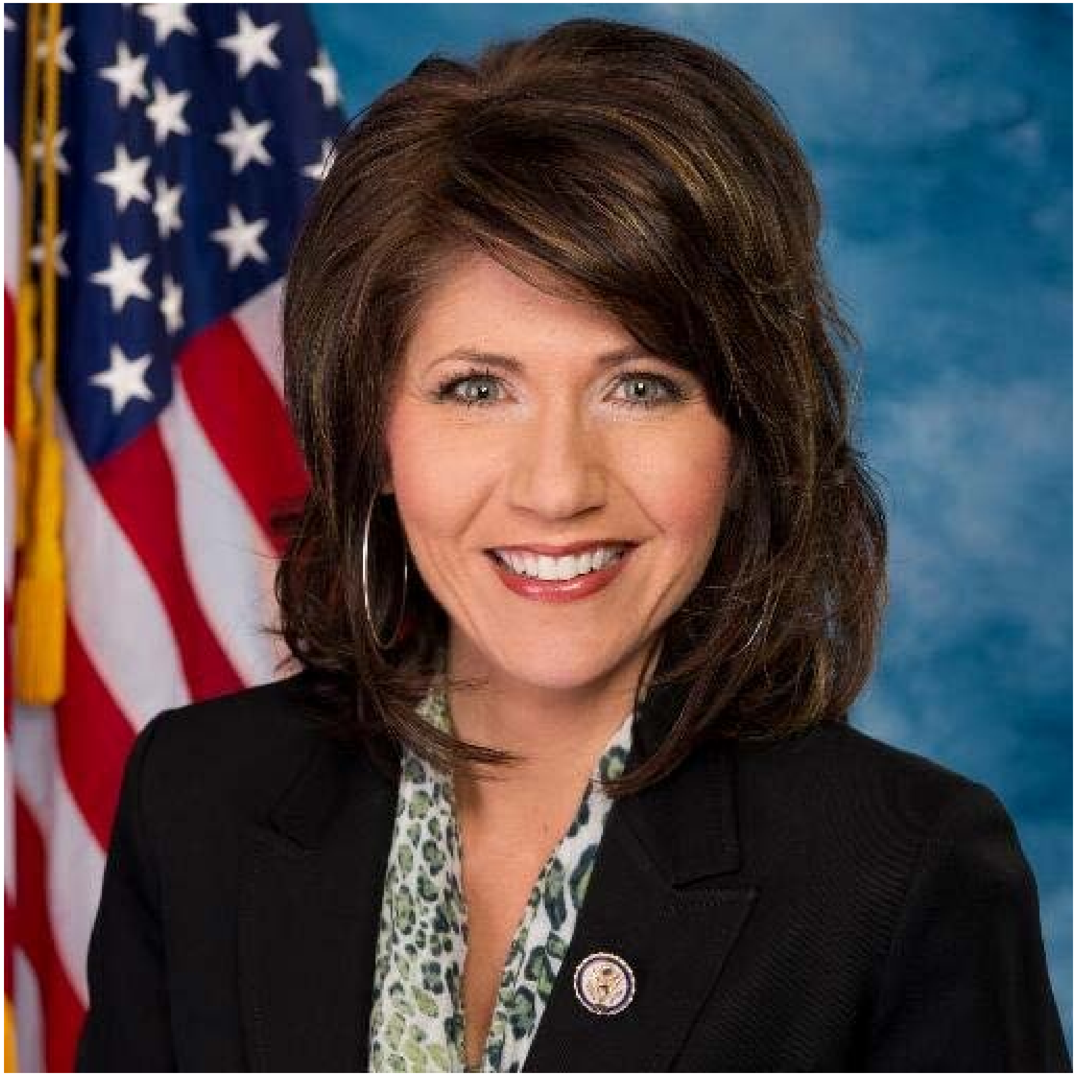
General Description

- Alters individual income taxation
- Reduces corporate income taxes
- New form of taxing pass-through income
- Modified territorial system
- Doubles estate tax exemption to $11,180,000 (estimate)

Doubling of the estate and gift tax basic exclusion amount and GST exemption

2018 Amounts for Individuals	
Gift & Estate Tax Basic Exclusion Amount	$11.18M
GST Exemption Amount	$11.18M

Who is this?



Estate and Gift Planning

- Sunset on January 1, 2026
  - Increased gift and estate tax exclusion amount and GST exemption sunset
  - Most individual income tax provisions sunset, with limited exceptions

- Chained Consumer Price Index
  - Department of Labor Chained Consumer Price Index for All Urban Consumers
  - Slows increases in rate brackets
  - Change to C-CPI-U index does not sunset

- Clawback
  - Unlikely, but not impossible

Estate planning techniques to be considered

- Gifts to existing or new irrevocable trusts
- Leveraging gifts
- Pairing gifts with philanthropy
- Flexibility in the use of portability or credit shelter trusts at the first spouse’s death

International Estate Planning

- Exemption for NRAs remains at $60,000
- No change to rate schedule
- New concerns about use of foreign blocker corporations by NRAs

Income Taxes

- ➢Changes to income taxes for individuals, estates and trusts
  - MOST only in effect during Covered Years
- ➢Corporate tax changes are permanent for most part

The Taxman Giveth…and the Taxman Taketh Away

Household Gains and (Losses) from the Tax Cuts and Jobs Act of 2017 2018-2027, $ billions			
Lower tax rates and wider income brackets	1,214	Repeal of personal exemptions	(1,212)
Higher standard deductions	720	Limitation on SALT and mortgage interest	(668)
Increased AMT exemptions and phase-outs	637	Repeal the ACA individual mandate	(314)
Increase the child tax credit	544	Change in inflation adjustment	(134)
20% deduction on pass-through income	265	Miscellaneous	(9)
Higher estate and GST exemptions	83		
Addition to household income	3,463	Subtraction from household income	(2,337)
Net Benefits	1,127		

Source: The Joint Committee on Taxation and BBH Analysis.

Unmarried Individuals

New 2018 Tax Brackets and Rates

Not over $9,525	10%
Over $9,525 but not over $38,700	12%
Over $38,700 but not over $82,500	22%
Over $82,500 but not over $157,500	24%
Over $157,500 but not over $200,000	32%
Over $200,000 but not over $500,000	35%
Over $500,000	37%

Married Individuals Filing Joint Returns and Surviving Spouses

New 2018 Tax Brackets and Rates	
Not over $19,050	10%
Over $19,050 but not over $77,400	12%
Over $77,400 but not over $165,000	22%
Over $165,000 but not over $315,000	24%
Over $315,000 but not over $400,000	32%
Over $400,000 but not over $600,000	35%
Over $600,000	37%

Estates and Trusts	
New 2018 Tax Brackets and Rates	
Not over $2,550	10%
Over $2,550 but not over $9,150	24%
Over $9,150 but not over $12,500	35%
Over $12,500	37%

Individual Income Tax Planning

- Kiddie Tax
  - No longer applies parents' income tax rate to minor's unearned income
  - Tax Act applies the income and capital gains rates applicable to trusts and estates to a child's unearned income
    - 10% up to $2,550
    - 24% up to $9,150
    - 35% up to $12,500
    - 37% on excess over $12,500
  - Change to Standard Deduction

Individual Income Tax Planning

- Modification and Elimination of Deductions
  - State, local and foreign taxes
    - Deduction for state and local income, sales, and property taxes that are not related to a trade or business is limited to $10,000 for joint filers and unmarried individuals and $5,000 for a married individual filing separately
    - Not indexed figures
  - Deduction for home mortgage interest
    - Deduction limited to interest paid on acquisition indebtedness incurred after December 15, 2017 of up to $750,000 (previously $1,000,000)
    - Not an indexed figure
  - Suspension of deduction for interest on home equity indebtedness
  - Alimony deduction eliminated (permanent)

Modification to Alternative Minimum Tax Exemption Amount

AMT Exemption Amounts			
2017 AMT Exemption Amounts for Individuals		New AMT Exemption Amounts for Individuals	
Unmarried Individuals	$54,300	Unmarried Individuals	$70,300
Married Individuals Filing Joint Returns	$84,500	Married Individuals Filing Joint Returns	$109,400
Estates and Trusts	$24,100	Estates and Trusts	$24,100

- Threshold for phase out increased to $1,000,000 for married individuals

Permanence of Roth IRA Conversions

Taxation on U.S. Businesses and C Corporations

- Corporate income tax flat rate of 21 percent
- Corporate AMT repealed
- Corporate net operating losses limited
- Top marginal rate on distributions of 39.8% (21%+(79%*23.8%))
- No sunset

Economic Implications of Corporate Tax Reform

Corporate Gains and (Losses) from the Tax Cuts and Jobs Act of 2017 2018-2027, $ billions			
21% statutory corporate tax rate	1,349	Changes to the treatment of foreign operations	(377)
Accelerated expensing of investments	112	Other limitations on corporate deductibility	(352)
Other international tax changes	53	Limitation on deductibility of interest paid	(253)
		Limit use of net operating losses	(201)
Addition to corporate income	1,514	Subtraction from corporate income	(1,184)
Net Benefits	330		

Source: The Joint Committee on Taxation and BBH Analysis.

Pass-Throughs – Section 199A

Norman Mingo

WHAT ME WORRY?

Income Taxation of Pass-Thru Entities

- Deduction for qualified business income from pass-thru entities to individuals and trusts and estates.

- 20% deduction against pass-thru business income for joint filers up to $315,000 of income.

- If the income of the joint filer is above $315,000, the deduction is limited to the lesser of:
  - 50% of W-2 wages of qualified business; or
  - 25% of W-2 wages plus 2.5% the unadjusted basis of all qualified property

- These provisions, like most other individual tax provisions, are not permanent and sunset January 1, 2026.

Income Taxation of Pass-Thru Entities

- Income from certain specified service companies is phased out and ultimately eliminated

- These include: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerages services, reputation/skill-based services, investment management/trading

- Architecture/engineering businesses are not per se excluded

Income Taxation of Pass-Thru Entities

- How will these “disfavored” categories be interpreted?
  - Section 1202?
  - Section 448(d)?
- What is the definition reputation or skill-based?
- How does rental property fit in? “real estate” exception to wage limitation?
- Can one entity have multiple trades/businesses?
- Will the IRS aggregate various entities owned by one taxpayer or among common taxpayers?

Taxation of U.S. Businesses

- Carried interests
- Business interest expenses
- Bonus depreciation
- Like-kind exchanges
- Entertainment deductions largely eliminated

Charitable Issues

- Charitable contribution deduction percentage limitations
- UBIT
- College and University Endowments

Broadening Use of 529 Accounts

- Now includes qualified expenses for elementary and high school education up to $10,000 per year, per student
- Expansion of able accounts, including limited roll-overs from 529 to able

Fiduciary Income Taxation

- Tax Rates
- Trusts and Estates Retain Personal Exemptions
  - Estate $600
  - Complex trust $100
  - Simple trust $300
- Items still deductible under Section 67(e):
  - Trustee Fees
  - Legal fees related to the administration of a trust or estate
  - Cost of preparing estate tax returns and fiduciary income tax return
  - Administrative fees for items such as appraisals and accountings
  - State and local income and property taxes on assets held in a trust or estate up to the $10,000 limitation

Fiduciary Income Taxation

- Items still deductible under Section 67(e) (cont’d):
  - State personal and real estate taxes on a trade or business owned by a trust or estate
  - Interest (subject to the same rules and limits as before 2018)
  - Charitable distributions for amounts specifically allocable or payable to charity by the governing will or trust instrument pursuant to Section 642(c)
  - Amortized bond premiums and original issue discount.

- Electing Small Business Trusts
  - Nonresident aliens are now permissible ESBT beneficiaries
  - Charitable contribution deduction of an ESBT determined by rules applicable to individuals under section 170 rather than the rules applicable to trusts under section 642(c)
  - Changes do not sunset

691(c) Deduction for Income in Respect of a Decedent Taxed to Estate OR BENEFICIARY

Planning for Clients in Light of Tax Reform

- Primary Areas of Consideration/Discussion
  - Recommended Estate Planning Structure for (Joint) Estates under $20 million
  - Planning for the Sunset as of January 1, 2026
  - Tax allocation of GST-Tax exemption
  - Addressing the potential of a "clawback" of transfer tax exemption and apportionment of potential transfer taxes on gifts and bequests

- Further Considerations
  - State Estate Tax
  - Modifying existing trusts for basis step-up
  - Evaluating other existing estate planning

Planning for Clients in Light of Tax Reform

- Recommended Estate Planning Structure for (Joint) Estates under $20 million
  - Increased use of disclaimer and formula planning
    - Allows for post-mortem decision on trust funding and use of exemption
    - May not be appropriate in all family situations
  - Over-funded credit shelter trust can have costs
    - No step up in basis at death of surviving spouse
    - Income taxation of credit shelter trust
    - Evaluate interest of surviving spouse in credit shelter trust as qualifying for elective share
  - Strike a balance?
    - Formula driven allocation based on minimum funding of marital trust/share
    - Grant power to third party to allocate trust assets between shares (limited power of appointment)

Planning for Clients in Light of Tax Reform

- Planning for the Sunset as of January 1, 2026
  - Alternative funding language based on law (remember pre-2010 drafting?)
    - If exemption amount is $11 million (or more) then fund as follows
    - If exemption amount has reverted to pre 2017 Tax Act level, then fund as follows
  - Use increase in GST Tax Exemption
    - Consider allocating GST exemption to non-exempt trusts
      - Late allocation based on current fair market value of trust assets
      - Review trust provisions to ensure efficient and appropriate use of exemption
    - Evaluate existing GRATs and QPRTs set to expire prior to 1/1/2026 to allocate exemption at end of term
    - Clawback possible but not likely

Planning for Clients in Light of Tax Reform

- Addressing the potential of a “clawback” of transfer tax exemption and apportionment of potential transfer taxes on gifts and bequests
  - Code section 2001(g)
  - Congress punts to Treasury on the issue
  - Most commentators agree what law will be under current administration
- Assume there is no clawback, and:
  - Current exemptions are extended (or made permanent); or
  - Increased exemptions expire at the end of 2025 as planned
- But what if there was clawback?
  - Estate and gift tax issues
  - Tax apportionment issues
- Counsel clients on hypothetical risks

Planning for Clients in Light of Tax Reform

- Further Issues for Consideration: State Estate Tax
  - Eighteen jurisdictions retain a state transfer tax: Connecticut, the District of Columbia, Hawaii, Illinois, Iowa (inheritance tax only), Kentucky (inheritance tax only), Maine, Maryland, Massachusetts, Minnesota, Nebraska (county inheritance tax only), New Jersey (inheritance tax only), New York, Oregon, Pennsylvania (inheritance tax only), Rhode Island, Vermont, and Washington
  - Federal estate tax deduction remains for payment of state estate tax
  - Top state tax rate is generally16% (49.6% combined top federal and state rates)
  - Nonresident taxpayers may face state transfer tax issues for property located in such a state
  - State QTIP elections (9 jurisdictions)
  - No state estate tax portability (except Hawaii) complicates funding considerations at death of first spouse
  - Change in domicile

Planning for Clients in Light of Tax Reform

- Further Issues for Consideration: “Portability”
  - Deceased spousal unused exclusion (DSUE)
  - Value of portability to family:
    - Approximately twice as valuable for estate tax purposes
    - Approximately twice as valuable for income tax purposes (basis step-up)
    - Temporary (only for 2018-2025 decedents)
  - Gifting by donors with existing DSUE
  - Review funding formulas and make portability election as needed
  - Clawback?
  - GST tax exemption not portable
  - As noted, portability generally not helpful for state estate taxes

Planning for Clients in Light of Tax Reform

- Further Issues for Consideration: Modifying existing trusts and planning for basis step-up
  - Review terms of governing trust instrument
    - Revocable vs. irrevocable trusts
    - Beneficiary withdrawal rights and powers of appointment
    - Distributions for "best interests"
    - Trust protectors
  - Look to state law for solutions if irrevocable trust inflexible
    - Decanting statutes
    - Nonjudicial settlement agreement statutes
    - Directed trustee statutes
    - Judicial modification

Planning for Clients in Light of Tax Reform

- Further Issues for Consideration: Evaluating other existing estate planning
  - Life insurance
  - Family limited partnerships / LLCs
  - Grantor retained annuity trusts (GRATs)
  - Intentionally defective grantor trusts (IDGTs)
  - Installment sales to IDGTs
  - Client desire for simplicity vs. non-tax benefits of estate planning structures

Case Study A

- Anne is a widow whose husband died in 1995
- She and the children are beneficiaries of a credit shelter trust originally funded with $600,000
- Current value of trust assets = $1,000,000
- Anne's other assets are valued at $3,000,000
- Anne is 89 years old

Case Study B

- Bob and Sandy are 65. They have two children and four grandchildren. They live in Virginia (no state estate tax).
- They have assets of $10 million
- Current estate plan relies on portability
- Variations:
  - Live in state with estate tax
  - Second marriage, they each have two children and four grandchildren
  - Assets of $20 million
  - Age 85

Case Study C

- Carlos and Maria are in their 40s
- They have three minor children
- They have assets in excess of $100 million, largely from the sale of a business Maria started and sold
- Both Carlos and Maria are currently involved with new start up businesses

Case Study D

- Diana is a 85 year old widow whose husband Art died 20 years ago
- Prior to Art's death, they formed an FLP and funded it with real property and securities
- Art's interest in the FLP passed to their 3 children and 3 GST trusts at his death
- Diana made gifts of ~$5 million prior to this year
- Diana still owns 27% of the FLP (FMV ~$4 million)
- Diana has assets outside the FLP (FMV ~5 million)

Case Study E

- Ed owns a successful construction business worth $20 to $40 million, as well as a large home and other assets
- Ed and Jennifer have 5 children, all minors
- Ed supports his mother Frances, who is 75, has very few assets, and is in relatively poor health

Case Study F

- Fran founded a manufacturing business taxed as an S-corporation and has, over the years given, and sold 70% to children/grandchildren and (PRIMARILY) to a multi-generation, grantor trust
- Fran, now 87 and retired, holds a note from the grantor trust
- Various family members work for the company and all enjoy distributions
- The company would like to make investments and benefit from the 21% income tax rate

Case Study G

- George, an accomplished professional athlete, provides life-style advice, conducts fitness consulting and sells various fitness / diet products
- can the advice/consulting services be separated from the fitness/diet products? What about book sales? Or online course subscriptions about health generally?
- How important is George's personal reputation to the company?
- Can George associate with other similar gurus to "diminish" the importance of his personal skills to the enterprise?

PART B

Recent Developments

1. IRS Proposes Regulations on Section 199A (August 8, 2018)

- IRS proposes new regulations on passthrough deduction under new Section 199A

2. Notice 2018-54, 2018-24 I.R.B. 750 (May 23, 2018)

- IRS provides guidance on certain payments made in exchange for state and local tax credits

3. Press Release: Treasury Issues Proposed Rule on Charitable Contributions and State and Local Tax Credits (August 23, 2018)

- Department of Treasury issues proposed rule on federal income tax treatment of payments and property transfers under state and local tax credit programs

4. 2017–2018 Priority Guidance Plan (October 20, 2017)

- Treasury Department and the Internal Revenue Service release their 2017–18 priority guidance plan

5. Revenue Procedure 2017-58, 2017-45 I.R.B. 19 (October 19, 2017)

- Inflation adjustments for 2018 announced

6. Letter Rulings on Extension of Time to Make Portability Election

- **Extension of time to make portability election permitted**

7. Notice 2017-12, 2017-5 I.R.B 742 (January 6, 2017)

- IRS provides guidance on methods available to confirm closing of the estate tax return examination

8. Letter Ruling 201751005 (Issued September 18, 2017; Released December 22, 2017)

- IRS grants extension of kind to make QTIP election

9. Karen S. True v. Commissioner, Tax Court Docket No. 21896-16 and H. A. True III v. Commissioner, Tax Court Docket No. 21897-16 (Petitions filed October 11, 2016)

- IRS attacks use of Wandry clause in gift and sale of interests in a family business

10. Letter Rulings 201744006 and 201744007 (Issued July 26, 2017; Released November 3, 2017

- Contributions of property to trust by grantors is not a completed gift subject to gift tax

11. Letter Ruling 201803003 (Issued October 6, 2017; Released January 9, 2018)

- Proposed trust modifications will not trigger gift or generation-skipping tax

12. Letter Ruling 2018808002 (Issued January 6, 2017; Released February 23, 2018)

- Service rules on gift tax consequences of gift of life estate interest in pre-October 9, 1990 transaction

13. Letter Ruling 201825003 (Issued March 9, 2018; Released June 22, 2018)

- Transfer of the legal title, naked ownership, and remainder interest in and to artwork as defined by the deed of transfer is a completed gift for gift tax purposes

14. Estate of Sommers v. Commissioner, 149 T.C. No. 8 (2017)

- Tax Court denies estate tax deduction for gift tax owed at death by decedent on gifts to decedent's nieces

15. Letter Rulings 201737001 and 201737008 (Issued June 14, 2017; Released September 15, 2017)

- Reformation of power of appointment to make it a limited power of appointment is recognized

16. CCA 201745012 (Issued August 4, 2017; Released November 9, 2017)

- Purchase of remainder interest in transferred property in which donor retained annuity, which purchase occurred on donor’s death bed during the term of the annuity, failed to replenish donor’s taxable estate and failed to constitute adequate and full consideration for gift tax purposes

17. Badgley v. United States, _____ F.Supp.3d _____ (ND Cal 2018)

- The assets of a GRAT are included in the settlor’s estate

18. Letter Ruling 201819010 (Issued February 8, 2018; Released May 11, 2018)

- IRS grants extension of time to make Section 754 election

19. Letter Ruling 201743013 (Issued July 26, 2017; Released October 27, 2017)

- Grandson’s sale of interest in specially valued farm property to Daughter within 10 years of decedent’s death will not cause an additional tax under Section 2032A

20. Letter Ruling 201814004 (Issued December 11, 2017; Released April 6, 2018)

- IRS allows extension of time to make special use valuation election for farmland

21. Letter Ruling 201820010 (Issued February 13, 2018; Released May 18, 2018)

- IRS allows extension of time for estate to elect alternate valuation date

22. Letter Ruling 201815001 (Issued December 11, 2017; Released April 13, 2018)

- IRS allows extension to elect alternate valuation date

23. Letter Ruling 201825013 (Issued March 19, 2018; Released June 22, 2018)

- **IRS grants an extension of time to make the alternate valuation election**

24. Estate of Clara M. Morrissette v. Commissioner, ___ Tax Court Order (June 21, 2018)

- **Court denies partial summary judgment motion of estate that Section 2703 does not apply to split-dollar arrangement**

25. Cahill v. Commissioner, T.C. Memo 2018-84

- **Taxpayer's motion for summary judgment with respect to split-dollar arrangement is denied**

26. RERI Holdings LLC v Commissioner, 149 T.C. No. 1 (July 3, 2017)

- Tax Court denies income tax charitable donation for gift of LLC interest

27. 310 Retail, LLC v. Commissioner, T.C. Memo 2017-164

- **Deed of easement constitutes contemporaneous written acknowledge for charitable income tax deduction for gift of conservation easement**

28. Big River Development, LP v. Commissioner, T.C. Memo 2017-166

- Deed of easement constitutes contemporaneous written acknowledge of charitable gift

29. Ohde v Commissioner, T.C. Memo, 2017-137

- **Husband and Wife denied income tax charitable contribution deduction for over 20,000 items donated to Goodwill Industries in 2011**

30. Roth v. Commissioner, T.C. Memo 2017-246

- Couple liable for penalties for overstating value of easement donation

31. Wendell Falls Development, LLC v. Commissioner, T.C. Memo 2018-45

- **No charitable contribution deduction is allowed for the donation of a conservation easement and no penalty is applicable**

32. Notice 2017-73, 2017-51 IRB 562 (December 4, 2017)

- IRS describes approaches being considered to address certain issues regarding Donor Advised Funds

33. Letter Ruling 201750014 (Issued September 12, 2017; Released December 15, 2017)

- Extension of time granted to sever a marital trust into exempt and non-exempt trust and to make a reverse QTIP election

34. Letter Rulings 201820007 and 201820008 (Issued February 5, 2018; Released May 18, 2018)

- Proposed distribution from one generation-skipping tax exempt trust to another exempt trust will not cause either trust to lose their exempt status

35. Letter Ruling 201815012 (Issued November 14, 2017; Released April 13, 2018)

- Extension of time granted to allocate spouse's available GST exemption

36. Letter Ruling 201747002 (Issued August 9, 2017; Released November 24, 2017)

- Executor granted extension of time to allocate decedent’s GST exemption to family trust

37. Letter Ruling 201801001 (Issued September 20, 2017; Released January 5, 2018)

- Estate granted an extension of time to allocate GST exemption

38. Letter Rulings 201803001 and 201803002 (Issued September 18, 2017; Released January 19, 2018)

- Extension of time to allocate GST exemption granted

39. Letter Rulings 201811002 and 201811003 (Issued November 27, 2017; Released March 16, 2018)

- Service rules on application of split-gift rules to the allocation of GST exemption

40. Letter Ruling 201736017 (Issued June 1, 2017; Released September 8, 2017)

- **IRS permits an extension of time to elect out of the automatic allocation rules with respect to GST tax**

41. Letter Ruling 201737006 (Issued June 12, 2017; Released September 15, 2017)

- Extension of time to opt out of automatic allocation rules for GST exemption permitted

42. Letter Ruling 201737007 (Issued June 1, 2017; Released September 15, 2017)

- **IRS permits taxpayer to opt out of automatic allocation GST exemption**

43. Letter Rulings 201743004 and 201743005 (Issued July 3, 2017; Released October 27, 2017)

- IRS allows extension to elect out of the automatic allocation of GST exemption rules

44. Letter Rulings 201731005 and 201731010 (Issued April 3, 2017; Released August 4, 2017)

- Taxpayer found to have complied with the essential requirements necessary to allocate GST exemption to irrevocable trust

45. Letter Ruling 201735009 (Issued May 25, 2017; Released September 1, 2017)

- Judicial reformation of trust will not subject the trust to GST tax

46. Letter Rulings 201814001 and 201814002 (Issued December 11, 2017; Released April 6, 2018)

- **Construction of ambiguous terms of grandfathered GST trust will have no adverse generation-skipping tax, gift tax, or income tax consequences**

47. Letter Ruling 201818005 (Issued January 16, 2018; Released May 4, 2018)

- Partition of trust in accordance with terms of partition order will have no adverse income, gift, or generation-skipping tax consequences

48. Letter Ruling 201825007 (Issued March 15, 2018; Released June 22, 2018)

- Modification of GST grandfathered trust will not affect exempt status

49. Letter Ruling 201825023 (Issued March 9, 2018; Released June 22, 2018)

- IRS grants decedent’s estate an extension of time to sever a residuary trust into an exempt and non-exempt residuary trust

50. Letter Ruling 201732029 (Issued April 20, 2017; Released August 11, 2017)

- Reformation of grandfathered GST Trust to correct scrivener's error will have no adverse estate, gift, or generation-skipping tax consequences

51. Letter Ruling 201735005, (Issued May 8, 2017; Released September 1, 2017)

- Inadvertent payment by trust beneficiary of federal and state income taxes will not have adverse estate, gift, or GST tax consequences

52. Letter Ruling 201807001 (Issued November 13, 2017; Released February 16, 2018)

- IRS recognizes reformation of trust to qualify as a grantor trust for income tax purposes

53. Letter Ruling 201803004 (Issued September 28, 2017; Released January 19, 2018)

- IRS grants extension to trust for charitable contribution election

54. Green v. United States, 880 F.3d 519 (10th Cir. January 12, 2018)

- Income tax charitable deduction for non-grantor trust limited to trust’s adjusted basis in properties donated to charity

55. Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, _____ N.C. _____ (2018)

- N.C. Supreme Court holds that income taxation of out-of-state trust is unconstitutional

56. Fielding v. Commissioner, ____ Minn. ___ (July 18, 2018)

- Attempt of Minnesota to tax irrevocable non-grantor trusts as resident trusts for state income tax purposes is unconstitutional under the due process clauses of United States and Minnesota Constitutions

57. Notice 2018-61, 2018-31 IRB (July 13, 2010)

- IRS to issue regulations on effect of Section 67(g) on certain deductions for estates and nongrantor trusts

58. Georgia House Bill 441

- Georgia Governor vetoes domestic asset protection trust legislation

59. Toni 1 Trust v. Wacker, ___ AK ___ (March 2, 2018)

- Alaska Supreme Court determines that Alaska state courts do not have exclusive jurisdiction over fraudulent transfer actions under AS 34.40.110(k)

60. In re Olson, ___ F. Supp. 3d ___ (C.D. Cal 2018)

- U.S. District Court declines to approve settlement of bankruptcy trustee with respect to offshore trust

61. In re Matter of the Estate of Anne S. Vose v. Lee, 390 P.3d 238 (Okla. Jan. 17, 2017)

- Decedent’s executor had a fiduciary obligation to the surviving spouse to file an estate tax return to elect portability of the deceased spousal unused exclusion amount even though under a premarital agreement the surviving spouse was not an heir or distributee of the decedent’s estate

62. Du Pont v. Wilmington Trust Company, C.A. No. 12839-VCS (Del. Ch. Oct. 6, 2017)

- Delaware Chancery Court refuses to grant trust beneficiary’s petition to remove the trustee of five directed trusts when the grounds for removal did not relate directly to matters of trust administration

63. Saccani v. Saccani, No. C078958, 2016 WL 6068962 (Cal. Ct. App. Oct. 17, 2016)

- California court interprets a shareholder agreement to permit a shareholder's pre-death transfer of shares to a revocable trust after that shareholder gave another shareholder the option to purchase the shares after the transferring shareholder's death, even though the shareholder agreement itself only authorized share transfers to trusts for the benefit of a shareholder's descendants

64. Gray v. Binder, 805 S.E.2d 768 (2017)

- The Commissioner of Accounts had the authority to hear a petition filed by the administrator of an estate for advice and guidance regarding the interpretation of the will and the determination of the proper heirs of the decedent

65. Lawson v. Collins, No. 03-17-00003-CV, 2017 WL 4228728 (Tex. App. Sept. 20, 2017)

- An arbitration award is final and binding on all participating parties and has the effect of a court order, regardless of whether all parties agree to the terms of the arbitration award. Absent evidence of statutory grounds for overturning such award, or evidence that such award is the result of fraud, misconduct or gross mistake, an arbitration award will be affirmed and confirmed

66. Ajemian v. Yahoo!, Inc. 84 N.E. 3d 766 (Mass. 2017), petition for cert. docketed sub nom. Oath Holdings, Inc. v. Ajemian (U.S. Jan. 19, 2018) (No. 17-1005)

- The Stored Communications Act (the "SCA") does not prevent Yahoo!, Inc. ("Yahoo") from voluntarily disclosing emails from a decedent's account to the decedent's personal representatives at the request of the personal representatives; it remains to be settled whether the SCA compels Yahoo to do the same

67. Higgerson v. Farthing, 2017 WL 4224476 (Va. Cir. Ct. 2017)

- A Trustee was held liable for breach of fiduciary duty and for excessive fees where the trustee was unnecessarily engaged in aggressive day trading and margin trading and his fees were not reasonable in relation to the work actually required to fulfill his fiduciary duties

68. Bradley v. Shaffer, 535 S.W.3d 242 (Tex. App. 2017)

- The transfer of a beneficial interest in trust property by a beneficiary was void because the trust contained a valid spendthrift provision, and the doctrine of after-acquired title is not applicable to a void transfer

69. Hodges v. Johnson, 2017 WL 6347941 (N.H. 2017)

- The Supreme Court of New Hampshire affirmed an order declaring a trust decanting void ab initio and removed the trustees for breach of duty of impartiality

70. Matter of Sinzheimer, 2017 N.Y. Slip Op. 31379(U) (Surr. Ct. New York Cnty.)

- Corporate trustee removed under the terms of the trust was not required to deliver the trust assets to individual co-trustee when a successor corporate trustee had not been appointed

71. IMO Ronald J. Mount 2012 Irrevocable Dynasty Trust U/A/D December 5, 2012, No. CV 12892-VCS, 2017 WL 4082886 (Del. Ch. Sept. 7, 2017)

- Delaware Chancery Court holds that a trust instrument may allow a trust protector to act in a non-fiduciary capacity. Therefore, it dismissed a claim against a trust protector for breach of fiduciary duties

72. Laborers’ Pension Fund v. Miscevic, No. 17-2022 (7th Cir. Jan. 29, 2018)

- **ERISA does not preempt the Illinois slayer statute, and the Illinois slayer statute applies where the deceased was killed by an individual found not guilty by reason of insanity**

73. Metropolitan Life Ins., Co. v. Teixeira, Civ. No. 16.07486 (D.N.J. 2017)

- **Interpleader protection does not extend to counterclaims that are not claims to the interpleaded funds**

74. Harvey ex rel. Gladden v. Cumberland Tr. & Inv. Co., 532 S.W.3d 243 (Tenn. 2017)

- Trustee had authority to enter into predispute arbitration agreement with financial advisor, and outcome of arbitration bound beneficiaries

75. Berkenfeld v. Lenet, _______ F.Supp.3d ________ (D. Md. 2018)

- Broker not liable for annuity beneficiaries taking lump sum distributions

76. Estate of Rubin A. Meyers v. Commissioner, T.C. Memo 2017-11

- Recipients of assets received by means other than a will or state law governing the distribution of a deceased person's property could be liable for unpaid estate taxes ten years later

77. Estate of Marion Levine v. Commissioner, No. 13370-13 (October 26, 2017)

- Estate granted protective order limiting scope of IRS subpoena

78. Hawk, Billy F., Jr. GST Non-Exempt Marital Trust, et al. v. Commissioner, T.C. Memo 2017-217

- Decedent’s estate, two marital trusts and decedent’s widow were liable as transferees under Section 6901 and applicable state law for unpaid income taxes from the sale of a bowling alley

79. United States v. Raelinn M. Spiekhout, (In the Matter of Estate of Simmons), ___ F. Supp. 3d ___ (S.D. Ind. July 31, 2017)

- ➢ Government's tax liens have priority

80. Letter Ruling 201750004 (Issued September 12, 2017; Released December 15, 2017)

- Subtrust is valid see-through trust

81. Letter Ruling 201805011 (Issued November 2, 2017; Released February 2, 2018)

- IRS grants extension to waive family attribution rules

82. United States v. Paulson __ F. Supp.3d __ (S.D. Cal. 2018)

- Court denies defendant’s motion to stay proceedings pending decision of state court

83. Changes in state death taxes in 2018

- **Several states see changes in their state death taxes in 2018**

84. 2018 State Death Tax Chart (as of July 9, 2018)

Security National Bank

Charitable Planning

Monday, October 15, 2018
10:20 a.m. – 11:20 a.m.

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The McGuireWoods Private Wealth Services Group

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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Charitable Planning

I. **Introduction**

A. Charitable giving is an important part of many individuals' estate plans, both during life and at death. On the surface, charitable giving does not appear to be very complex. One need only select the organizations to which he wishes to make donations and either transfer the property during life or make a specific gift in his will. If one makes a lifetime gift, he can then claim a charitable deduction on his income tax return. The procedure just outlined is not so simple, however.

1. If a charitable deduction is to be allowed, the donor or his estate must be prepared to substantiate the value of the donation through written records. For individuals who make large lifetime charitable gifts, the substantiation requirements are significant.

2. There are a variety of complex rules for valuing property for income tax charitable deduction purposes, and limitations on the amount that can be deducted in any given year.

3. Individuals need to know these requirements and limitations so that their charitable giving will produce the desired tax results.

4. Furthermore, individuals need to know that the economic benefits of a charitable transfer by them may vary depending on the type of property given, when it is given, and the form of the gift.

B. Direct charitable giving may be unsatisfactory to some individuals.

1. An individual may wish to benefit a particular organization or take advantage of the tax benefits of the charitable deduction, but may lack the resources to make a large, outright gift.

2. The individual may possess adequate resources to make the gift, but wants to retain an interest in or control over the particular assets that he is giving to charity.

3. There are a number of alternatives to outright gifts that the individual may find useful in these cases, some of which also produce transfer tax benefits for the family or additional income tax benefits for the donor.

C. A very productive way for a tax adviser to approach charitable giving is to recognize that, if a client is already charitably inclined, there may be different ways of achieving comparable results for the charity. Some of these techniques can produce large tax savings for the client and the family unit at a cost of only a modest amount of complexity or inconvenience. There are three basic concepts which can be used to realize substantial tax benefits for taxpayers who are already charitably inclined:

1. Recognition of a broad moral commitment to charity on the part of the taxpayer and conversion of that obligation into a legally binding allocation of funds. Such action can trigger tax benefits which might otherwise never accrue to the taxpayer or which might otherwise become available in a less advantageous way. An example is the lifetime creation of a remainder interest for charity to replace a moral commitment to leave a charitable bequest by will. This produces an immediate income tax benefit in addition to the estate tax saving and may also permit a diversification out of appreciated assets into higher income investments without capital gain tax.

2. Shifting the recognition of income away from the taxpayer to a charitable entity and using that income to satisfy the charitable payments which the individual would have made in any event. Essentially, this means the use of pre-tax income at face value to satisfy charitable obligations rather than using after-tax income or assets. One example would be to bequeath an installment sale contract (which is income in respect of a decedent carrying an income tax liability if collected by the heirs) to charity rather than leaving a bequest of cash or securities with a stepped-up basis. A lifetime application of this concept would involve pre-funding future years' charitable giving through an intermediate charitable entity in order to shift future pre-tax income in partial satisfaction of the charitable commitment.

3. The advantage of deducting (for ordinary income tax purposes) the fair market value of appreciated long-term capital gain property without recognition of the gain. At a marginal income tax rate of 37%, and assuming the property would be sold eventually and the gain recognized, the donor can transfer $100 of appreciation to charity at a real cost of only $43.00. The donor has parted with $80 of realizable value after the 20% capital gains tax and received a tax savings of $37.00, producing a net cost of the difference, of $43.00. By contrast, a cash gift of $100 would cost $63.00, the amount contributed less the resulting tax savings ($37.00 assuming a 37% rate). This advantage is so substantial that an individual who is in a position to donate either cash or appreciated securities should always consider the possibility of contributing the securities and using the cash to replace the securities at current prices. At the very least, he has achieved a stepped-up basis for the securities (which could be very valuable on a subsequent disposition) at no cost except for a commission on the purchase.

   An important caveat is that the use of this technique is limited in certain ways. There are lower percentage limitations for such contributions, special rules apply for such gifts to private foundations, and, for gifts made before 1993, the appreciation element may not be not deductible in computing the alternative minimum tax. The practical effect of these limitations frequently turns out to be that taxpayers may, with careful planning, take fruitful advantage of the appreciated property donation as long as they do not use the approach too much in any one year.

D. Charitable Giving Is An Untapped Market

1. An ongoing study by Bank of America/US Trust shows that charitable giving is an untapped market at many banks and trust companies. "Study of High Net-Worth Philanthropy." Bank of America and The Center on Philanthropy at Indiana University, 2006, as last updated in 2016.

a. High Net-Worth Households was defined as households with more than $200,000 in annual income and assets in excess of $1 million (excluding the value of their home.)

b. Surveys were mailed to over 20,000 households in the United States.

c. The findings included:

(1) 91% of the households made a gift to charity in 2015 compared to only 59% of the general population.

(2) On average high net worth donors gave $25,509 to charity in 2015. In contrast, the general population gave $2,520 on average.

(3) Basic needs organization drew the greatest percentage of High Net-Worth Households (63%) followed by religious (50%), education (45%), environment (42%), and health (40%) organizations.

(4) Over 40% have made a bequest to charity in their wills, 26% have established a foundation or donor advised fund, and 16% use a charitable remainder trust.

(5) Most respondents felt that repeal of the estate tax would not affect their charitable giving. 50% of the respondents said that elimination of the charitable income tax deduction would not cause their charitable giving to decline.

2. Moreover, a large amount is estimated to pass to charity in the future. A 2014 study, which updated 1998 and 2003 studies, found that at least $59 trillion would pass from older generations to younger generations between 2007 and 2061. Charities would receive $20.6 trillion during this period. John Havens and Paul Schervish. "A Golden Age of Philanthropy Still

Beckons: National Wealth Transfer and Potential for Philanthropy." Boston College Center on Wealth and Philanthropy 2014.

3. One must conclude, based upon the numbers cited above, that many opportunities exist for enhanced charitable giving by trust and private banking customers. This is especially true when one examines the history of charitable giving by Americans.

   a. Americans are among the most generous people, ranking second only to Canadians in terms of average donations to charity.

   b. In 2017, Americans gave $410.02 billion to charities. This was a $19.7 billion increase over charitable giving in 2016 (Giving USA 2018: The Annual Report on Philanthropy for the Year 2017. Giving USA Foundation and researched and written by the Center on Philanthropy at Indiana University).

   c. Individuals gave $286.85 billion and contributed 70¢ of each dollar given to charity in 2017.

   d. Bequests totaled $35.7 billion in 2017.

   e. Corporate giving was $20.77 billion in 2017.

   f. Far more than one million charities are presently recognized by the IRS.

4. Given the generosity of individuals, coupled with the overwhelming value of the future transfer of wealth between generations, trust departments and private banking departments must seize the opportunity to explain the benefits of charitable giving to customers and private foundations.

II. Income Tax Deduction for Charitable Contributions

A. The deductibility of charitable contributions for income tax purposes is subject to two types of limitations.

1. **Percentage Limitations**. There are "percentage limitations" on the amount that an individual may claim as a charitable deduction against his gross income in any tax year.

2. **Valuation Limitations**. With respect to certain appreciated property contributed to charity, the individual may be required to use the property's tax basis, rather than its fair market value at the time of the contribution, for the purpose of determining the deductible amount of the contribution.

3. These limitations in each case affect only the income tax charitable deduction. They do not apply to the estate tax and gift tax charitable deductions.

4. In addition to the percentage and valuation limitations, the "Pease limitation" included in the American Taxpayer Relief Act of 2012 puts a limit on most itemized deductions, including the income tax charitable deduction, for high-income taxpayers (individuals with more than $250,000 of income and joint filers with more than $300,000 in income). Most itemized deductions will be reduced by the lesser of (1) three percent of the amount by which adjusted gross income exceeds those limitations, or (ii) eighty percent of the total itemized.

B. The maximum amount that an individual may claim as a charitable contribution deduction in a given year is 60 percent of his or her "contribution base." This amount was increased from 50 percent beginning in 2018 by the 2017 Tax Act.

1. An individual's contribution base is defined as his adjusted gross income computed without regard to any net operating loss carryback for the year (IRC § 170(b)(1)(F)).

2. The 60 percent limitation is available only for direct contributions to "public charities" (which category includes so-called private operating foundations and conduit foundations) (IRC § 170(b)(1)(A)). Organizations that fall into this category are often called "60-percent-type organizations." This limitation was added by the 2017 Tax Act and appears to only be available in years when the donor only makes cash gifts to public charities.

3. Not all gifts to such organizations are eligible for this 60 percent deduction, however. Contributions of certain appreciated property are subject to special limitations, discussed later. Further, contributions in trust are treated as "for the use of," rather than "to," the charity and also do not qualify for the 60 percent deduction (Treas. Reg. § 1.170A-8(a)(2)).

C. Deductions for contributions to organizations that are not public charities (so-called 30-percent-type organizations, which are primarily private nonoperating foundations), and contributions for the use of any charity, are subject to a more restrictive limitation of 30 percent of the individual's contribution base, or, if less, the difference between 60 percent of the individual's contribution base and the amount of the individual's contributions to 60-percent-type organizations (IRC § 170(b)(1)(B)).

EXAMPLE: In 2018, an individual contributes $25,000 in cash to a public charity and $15,000 in cash to a private nonoperating foundation. If the individual's contribution base is $60,000, the donation to the public charity falls within the 60 percent limitation for the individual ($36,000) and is fully deductible in 2018. The amount of the donation to the private foundation that the individual may deduct is whichever is less, (a) 60 percent of his contribution base ($18,000) or (b) the difference between his 60 percent limitation and his donation to the public charity ($36,000 - $25,000 = $11,000). Thus, the individual may deduct only $11,000 of his $15,000 contribution to the foundation in 2018.

D. A five-year carryover rule applies to amounts that an individual cannot deduct in a given taxable year (IRC § 170(d)). The individual in the preceding example could therefore carry over the remaining $4,000 contribution that was not deductible in 2018 and, subject to the same percentage limitations, claim it as a charitable deduction in the first available succeeding year through the year 2023.

E. The percentage limitations just discussed apply only to contributions of cash and ordinary income property (property which, if sold, would not result in long-term gain). In addition, in the case of ordinary income property, the amount of the contribution for which an individual may claim a charitable deduction is limited to the contributed property's cost, not its fair market value (IRC § 170(e)(1)).

F. If an individual contributes long-term capital gain property to charity, different limitations may apply.

1. If the charity is a 60-percent-type organization, the percentage limitation on the deduction is 30 percent of the individual's contribution base if the individual is valuing the property at its fair market value (IRC § 170(b)(1)(C)(i)).

a. **Step Down**. The individual can increase the limit to 50 percent of his contribution base by electing to "step down" (reduce) the amount for which he is claiming a deduction by the amount of the long-term gain that would have been taxable had he sold the contributed property at its fair market value (IRC § 170(b)(1)(C)(iii)).

EXAMPLE: In 2018, an individual contributes $45,000 of appreciated securities to a public charity. The individual held the securities for more than one year before making the contribution. The individual's basis in the securities is $25,000. If the individual's contribution base is $60,000, he may deduct only $18,000 (30% of $60,000) of the contribution if he values the securities at fair market value for charitable deduction purposes. However, the individual may elect to step down the value of the securities for purposes of the deduction to $25,000 and deduct this amount in full, because it does not exceed 50 percent of his contribution base ($30,000). By stepping down the value, the individual has increased his charitable deduction for the current year.

b. An individual must consider the carryover rules when deciding whether to make the step-down election. In the preceding example, if the individual does not make the step-down election, he may carry over the $27,000 that is not deductible in 2018 to subsequent tax years. If he is in a 37 percent tax bracket, these additional deductions will create $9,990 in tax savings. If he makes the step-down election, the full $25,000 reduced value is deductible in 2018 but there is no carryover of any excess and no future tax savings from the contribution. In each case, the value of a larger immediate tax saving through a step-down election must be compared with the present value of future tax saving if step down is not elected.

c. Step down can be more attractive where the amount of appreciation is small or the donor dies after making a large contribution so that there are no succeeding years of the donor to which the excess contribution may be carried.

2. **Automatic Reduction to Basis**. If the donee of long-term capital gain property is a 30-percent-type organization, the percentage limitation on the deduction is whichever is less, (a) 20 percent of the donor's contribution base, or (b) the excess of 30 percent of the contribution base over the amount of contributions of long-term capital gain property to 60-percent-type organizations (IRC § 170(b)(1)(D)). In addition to this percentage limitation, there is an **automatic** reduction of the amount for which an individual can claim a deduction in the case of long-term capital gain property (other than certain public securities, as is discussed later) donated to a private nonoperating foundation (but not to any other 30-percent-type organization). The reduction again lowers the deductible amount to the adjusted cost basis of the property (IRC § 170(e)(1)(B)(ii)).

EXAMPLE: An individual contributes real estate valued at $10,000 to a private nonoperating foundation in 2018. The individual held the real estate for more than one year before the contribution. His basis in the property is $8,000 and his contribution base for the year is $50,000. If the individual made no other contributions during the year, he may claim a charitable contribution deduction of $8,000 for the contribution, which is his adjusted basis in the real estate. If the individual made the contribution to a 30-percent-type organization that is not a private nonoperating foundation, he could claim a deduction for the full $10,000 value of the real estate. In either case the contribution would be fully deductible since the deductible amount does not exceed 20 percent of his contribution base.

EXAMPLE: The individual in the preceding example also contributed a second parcel of real estate worth $10,000 to a public charity in 2018. In this case, the individual may deduct only $5,000 of the gift to the 30-percent-type organization (whether or not a nonoperating private foundation), because his deduction for the latter gift is limited to the difference between 30 percent of his contribution base ($15,000) and the $10,000 value of the long-term capital gain property given to the public charity.

a. For the purpose of applying the limitation on long-term capital gain property contributed to a 30-percent-type organization, the individual must value the long-term capital gain property that he contributed to 60-percent-type organizations in the same year at its fair market value, regardless of whether the individual made the step-down election with respect to the property contributed to the 60-percent-type organizations. Thus, in the preceding example, if the individual stepped down the value of the real estate contributed to the public charity to his adjusted basis of $5,000, he must nevertheless value that property at its $10,000 fair market value in calculating the limitation for his donations to 30-percent-type organizations.

b. The automatic reduction rule for gifts of long-term capital gain property to private nonoperating foundations does not apply to a donation of “qualified appreciated stock.” This is defined as stock that is readily tradable on an established securities market.

G. Special value reduction rules apply to contributions of tangible personal property held for more than one year (and therefore subject to long-term capital gain treatment) if use of the property by the charitable donee is unrelated to its exempt purpose or function. Such property is always reduced for deduction purposes by the amount of long-term gain that would have been taxable had the taxpayer sold the property at its fair market value. This rule applies to contributions to both 50-percent-type and 30-percent-type organizations (IRC § 170(e)(1)(B)(i)).

H. The 2006 Pension Protection Act addressed tangible personal property that is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the donor made the contribution and with respect to which the donee has not in a written statement signed by an officer of the donee under the penalties of perjury either (1) certified that the use of the property was related to the donee’s exempt purpose or function and described how the property was used and how such use furthered such purpose or function of the donee or (2) stated the intended use of the property by the donee at the time of contribution and certified that such use has become impossible or infeasible to implement.

1. If the property is disposed of after the close of the taxable year of the contribution and within three years of the date of the contribution (unless the donee makes the certification described above), the Act requires the recapture of the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property’s basis.

2. The Act also imposes a $10,000 penalty (in addition to any criminal penalties) on any person who identifies property as exempt use property knowing that the property is not intended for such a use.

3. The recapture provisions apply to contributions made after September 1, 2006. The penalty provisions apply to identifications of property made after the date of enactment.

4. The Act denies a deduction for any contribution by an individual, corporation, or partnership of clothing or a household item unless such item is in good used condition or better. Further, the Internal Revenue Service may, by regulation, deny a deduction for any contribution of clothing or a household item of minimal monetary value.

5. These limitations do not apply to any contribution of a single item for which a deduction of more than $500 is claimed if the taxpayer includes with the taxpayer's return a qualified appraisal of the item.

6. Household items include furniture, furnishings, electronics, appliances, linens, and similar items. Food, paintings, antiques, and other art objects, jewelry and gems, and collections are not included within these rules.

I. A provision of the 2004 Tax Act revised the rules for claiming tax deductions for charitable donations of motor vehicles, boats and airplanes valued at over $500. Section 731 of the Act limits the allowable amounts of such deductions to the gross proceeds received by the charity from the sale of the donated vehicle and requires the charity to provide donors with a written acknowledgment of their contributions within 30 days of the donation for all gifts after December 31, 2004.

J. The 2006 Pension Protection Act generally denied an income tax and gift tax charitable deduction for an undivided portion of a donor's entire interest in tangible personal property unless all interests in the property are held by the taxpayer or the taxpayer and the donee immediately before the contribution. The Internal Revenue Service may, by regulation, provide exceptions to the general rule for situations where all persons who hold an interest in the property make proportional contributions of an undivided interest.

1. The Act provides that in the case of any contribution of additional interests in the property, the fair market value of the contribution is the lesser of the fair market value of the property at the time of the initial contribution of a fractional interest and the fair market value of the property at the time of the contribution. Similar rules apply for estate tax purposes where the decedent made fractional interest contributions before death. This means that appreciation in value after the initial gift cannot be taken into account.

2. The new rules require that any charity that receives a fractional interest in tangible personal property must take complete ownership of the property within 10 years or upon the death of the donor, whichever occurs first. In

addition, the charity must have had substantial physical possession of the property during the 10-year period as long as the donor is living and used it in connection with its exempt purpose.

3. If these rules are not met, the Act requires recapture of the tax benefits associated with the contribution and imposition of a 10- percent penalty tax on the amount of the recapture. Recapture rules, as well as a 10-percent penalty tax, also apply for purposes of the gift tax.

III. **Substantiating the Charitable Deduction**

The IRS may disallow an individual's income tax charitable deduction if it is not properly substantiated. Recordkeeping requirements apply to all charitable contributions. Additional appraisal requirements apply to certain large contributions of property, other than cash or publicly traded securities.

A. Recordkeeping

1. For cash contributions to charitable organizations under the 2006 Pension Protection Act, a taxpayer may not claim a deduction for any cash or other monetary gift unless the taxpayer maintains as a record of the contribution a bank record or other written communication from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution.

2. If an individual makes a charitable contribution of property other than cash, he should obtain a receipt from the charity that shows the charity's name, the date and location of the contribution, and a description of the property contributed. If obtaining a receipt is impractical (e.g., because the donation is made at an unattended site, such as a clothing drop-off box) the donor may substitute his own written records (Treas. Reg. § 1.170A-13(b)(1)).

3. In addition to obtaining a receipt, a property donor should keep written records of any other information that may be necessary to substantiate the deduction (Treas. Reg. § 1.170A-13(b)(2)(ii)). For example, if the donor reduced the value of the property to its adjusted basis for purposes of the deduction, his records should include evidence of the property's basis.

4. Charitable contributions over $250, whether in cash or kind, to any donee must be substantiated by a "contemporaneous" written acknowledgment by the charitable organization. Without such substantiation, the deduction will be disallowed. An acknowledgment will be considered to be contemporaneous if it is made on or before the earlier of the date the return is filed or the due date for filing the return. The acknowledgment must include (1) the amount of cash and a description (but not value) of other property donated, and (2) a description and estimate of the value of any goods or services provided by the charity in consideration of the

donation. The substantiation requirement applies to all charities, including family private foundations, which means that acknowledgments must now be obtained for donations over $250 to family foundations. (IRC § 170(f)(8)). The IRS has issued final regulations in this area with an effective date of December 12, 1996 (Treas Reg. § 1.170A-13(f)).

5. If a deduction for a gift of property exceeds $500, the donor must maintain additional records. These records must contain information on the manner in which the donor acquired the property, the approximate date of acquisition, and, for property other than marketable securities, the cost or other basis of the property. If the donor held the property for more than six months before the contribution, the regulations require the maintenance of records on the property's basis only if such information is available (Treas. Reg. § 1.170A-13(b)(3)(i)).

B. Appraisal Requirements

1. Pursuant to a directive in TRA 1984, the Treasury Department has enacted temporary regulations that impose detailed appraisal requirements on individuals who make charitable contributions of property (other than cash or publicly traded securities) with a value in excess of $5,000. These regulations generally provide that no income tax charitable deduction will be allowed for contributions of such property unless the donor obtains a "qualified appraisal," and attaches a completed "appraisal summary" to the return on which he first claims the deduction. These requirements apply in addition to the recordkeeping requirements previously discussed.

2. Among the more important requirements for a qualified appraisal are that the appraisal must be made not more than 60 days before the date of contribution, describe the property appraised and the method of valuation used, be signed by the appraiser, and recite the appraiser's address, taxpayer identification number, and professional qualifications (Treas. Reg. § 1.170A-13(c)(3)). In addition, the appraisal must include a description of the fee arrangement between the donor and the appraiser. The appraiser generally cannot base his fee on a percentage of the appraised value of the property (Treas. Reg. § 1.170A-13(c)(6)(i)).

3. The appraiser used for a qualified appraisal must meet various requirements set forth in the regulations. The appraiser must hold himself out to the public as an appraiser and must be qualified to make appraisals of the type of property being valued. In addition, the appraiser may not be connected in any way to either the donor or the charity. The regulations specifically prohibit the donor, the charitable donee, or an employee of either from acting as the appraiser. With certain limited exceptions, a party to the transaction in which the donor acquired the property that is being appraised, or an employee of that party, cannot be the appraiser. The regulations also contain a catch-all provision that disqualifies any

appraiser whose relationship to any of the foregoing described parties would cause a reasonable person to question his independence (Treas. Reg. § 1.170A-13(c)(5)).

4. In addition to obtaining a qualified appraisal, the donor must complete an appraisal summary on a form prescribed by the IRS (currently Form 8283). The donor must obtain the signatures of the appraiser and the charitable donee on the form and attach it to the income tax return on which he first claims the deduction (Treas. Reg. §§ 1.170A-13(c)(2)(i)(B); 1.170A-13(c)(4)). In Hewitt v. Comm'r, 109 T.C. 258 (1997), the charitable deduction was reduced because of an improperly completed Form 8283 and the absence of a "qualified appraisal."

5. For the purpose of determining whether his contributions of property exceed $5,000, the donor must aggregate the values of similar items of property. For example, an individual who donates a number of paintings to different charities must aggregate the value of the paintings and satisfy the appraisal requirements if the aggregate value exceeds $5,000 (Treas. Reg. § 1.170A-13(c)(7)(iii)).

6. As previously mentioned, publicly traded securities are exempt from the appraisal requirements. Any share of stock, subscription right, bond, debenture, or other evidence of corporate indebtedness for which market quotations are readily available on an established securities market fall in this exempt category (Treas. Reg. § 1.170A-13(c)(7)(xi)).

7. The appraisal requirements are relaxed for charitable contributions of non-publicly traded stock where the claimed value of the donation exceeds $5,000 but does not exceed $10,000. In that case, no qualified appraisal is required and the donor must complete only part of the appraisal summary (Treas. Reg. § 1.170A-13(c)(2)(ii)).

8. Under Rev. Proc. 96-15, 1996-1 C.B. 627, the IRS permits a donor to receive from the IRS a binding statement of value for purposes of fixing the charitable deduction for certain donations of artwork. The artwork must have been appraised at $50,000 or more. A taxpayer can rely on a statement of value absent a misrepresentation of material facts in the application.

9. Provisions of the 2006 Pension Protection Act affecting qualified appraisals.

   a. The Act lowers the thresholds for imposing the accuracy-related penalty for a taxpayer claiming a deduction for property for which a qualified appraisal is required and eliminates the reasonable cause exception for gross misstatements.

b. The Act establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if the appraisal results in a substantial or gross valuation misstatement equal to the greater or $1,000 or 10% of the understatement of tax resulting from the misstatement, up to a maximum of 125% of the gross income derived from the appraisal unless the appraiser can establish that the value established in the appraisal was more likely than not the proper value.

c. The Act also defines a qualified appraiser and a qualified appraisal, which had previously been defined by regulation but not in the Internal Revenue Code.

d. The misstatement penalties apply to returns filed after the date of enactment. The appraiser provisions apply to appraisals prepared with respect to returns or submissions filed after the date of enactment. In the case of façade easements, however, the rules apply to returns filed after July 25, 2006.

IV. Charitable Remainder Trusts

A. A charitable remainder trust is an irrevocable trust under which one or more individuals receive a stated amount each year for a term of years (not exceeding 20), or for the life or lives of the individual or individuals, and at the end of the term, the remaining trust corpus is distributed to charity (Treas. Reg. § 1.664-1(a)(1)(i)).

B. The charitable remainder trust is used primarily to provide income security to the noncharitable beneficiary or beneficiaries, while at the same time obtaining an income tax charitable deduction. It often is used to avoid capital gains tax on appreciated assets that will be sold, either just so the upfront tax can be avoided or so the assets can be converted without diminution by taxes to an income stream. The trust may be created either irrevocably during life or at death. If created during life, the grantor may be the beneficiary of the stated income amount.

EXAMPLE: Jack transfers a $2 million parcel of appreciated real estate to a charitable remainder trust that will pay him a 6% annuity for life. The trust can sell the real estate without paying capital gains tax and invest the proceeds in income producing property. Jack has used the trust to convert the real estate to an income item of $120,000 per year. If he had sold the real estate without the trust and paid federal and state capital gains tax of $400,000, he would have had only $1,600,000 remaining, and taking 6% would have given him only $96,000 per year.

C. There are two types of charitable remainder trusts, which differ in the manner in which the stated annual amount to be paid to the noncharitable beneficiary is determined.

1. In a charitable remainder **annuity** trust, the stated amount must be a sum certain that is not less than 5 percent of the initial fair market value of the trust (IRC § 664(d)(1)).

2. In a charitable remainder **unitrust**, the stated amount must be a fixed distribution that is not less than 5 percent of the value of the trust assets, determined annually (IRC § 664(d)(2)).

3. Effective for transfers in trust after June 18, 1997, the annual payout from a charitable remainder annuity trust or unitrust cannot exceed 50 percent of the fair market value of the trust assets. Thus, a charitable remainder trust now must have payout rate of at least 5 percent, but not more than 50 percent. This change is meant to preclude an abusive use of charitable remainder trusts, and should not affect most individuals.

4. In addition, there is a requirement that the value of the remainder interest of a charitable remainder annuity trust or unitrust must equal or exceed 10 percent of the net fair market value of the property contributed to the trust on the date of its contribution. This 10-percent test is applied upon each transfer to the trust as of the date of the transfer in question. The change will impact primarily younger individuals who create charitable remainder trusts with lifetime annuity interests.

   EXAMPLE: Mr. Jones wants to transfer $1,000,000 to a charitable remainder trust and retain an annuity of $70,000 per year for his and Mrs. Jones' lives. Both Mr. Jones and Mrs. Jones are age 50. Under the IRS tables, this annuity interest has a value of $906,000, and the remainder interest has a value of $94,000. This is less than 10 percent of the value of the property transferred to the trust. The trust would not qualify as a charitable remainder trust.

   a. There are certain relief provisions in the event that a transfer fails to satisfy the 10-percent test.

      (1) First, a trust will be treated as satisfying the 10-percent test if the governing instrument is reformed, amended, or otherwise changed by reducing the payout rate or duration of the annuity (or both) within the period allowed for reformations under Section 2055(e)(3). In the example above, Mr. and Mrs. Jones' charitable remainder trust would satisfy the 10-percent test if the annuity was reduced to $68,000 per year.

      (2) Second, a transfer will be treated as if it never had been made if a court having jurisdiction over the trust declares the trust to be void (e.g., because the 10-percent test frustrates the purpose of the trust) and revocation

proceedings are commenced within the period allowed under Section 2055(e)(3).

(3) Finally, if an additional contribution is made after July 28, 1997 to a charitable remainder *unitrust* that was created before July 29, 1997, and that unitrust does not meet the 10-percent test with respect to the additional contribution, the additional contribution will be treated as if it were made to a new trust that does not satisfy the 10-percent test, but the status of the original unitrust will not be adversely affected.

b. The 10-percent test generally applies to transfers made after July 28, 1997; however, that test will not apply to a testamentary trust under an instrument that was executed before July 29, 1997 (i) if the instrument is not modified after that date and the grantor dies before January 1, 1999, or (ii) the grantor was under a mental disability on July 28, 1997 and at all times thereafter.

5. Net Income Only Charitable Remainder Unitrust.

a. A variation of a unitrust permits the trustee to pay only trust income if actual income is less than the stated percentage. This is called a net income-only charitable remainder unitrust. In most net income only unitrusts, the grantor also takes advantage of the provision that allows deficiencies in payouts (i.e., where trust income is less than the stated percentage) to be made up in later years if trust income exceeds the stated percentage (IRC § 664(d)(3); Treas. Reg. § 1.664-3(a)(1)(i)(b)). This net income make-up form of charitable remainder unitrust is known as a "NIMCRUT."

b. Use of an “income only” limitation offers the ability to build a substantial retirement fund for the noncharitable beneficiary (often the grantor or his spouse). During the beneficiary’s pre-retirement years, the trust assets can be invested for growth, with a shift over to current yield investments after retirement. The deficit make-up provisions would result in a substantial credit owed the beneficiary from the trust to boost the post-retirement payout.

EXAMPLE: An individual creates an income-only charitable remainder unitrust at age 50. The trust provides for a unitrust payment to the individual of 5%, or if less, the income earned by the trust. The individual funds the trust with $100,000, which is invested in common stocks yielding about 2% per year. At the end of 15 years, the trust fund is worth $197,993 because of the appreciation of the common stock, and the income-only provision has created a pay-out deficiency of $64,736. The individual retires, and the trust shifts its investment to bonds and notes yielding about 8%. The unitrust amount at this time is about $9,900 (5% of $197,893), but the trust will pay all its $15,840 of income (8% of $197,893) to the individual to make up the payout deficit from the first 15 years. This increased payout will last for about 11 years.

c. The IRS stated in one of its agent training manuals that the use of a NIMCRUT in the manner described in the example above may violate the self-dealing rules under Code Section 4941. The manual gives this example:

A is a major stockholder of Corporation M. A creates a NIMCRUT to pay a unitrust amount of 8% (or the trust income, if less) for his life and that of his wife. A funds the trust with $20 million of zero-basis M stock. The company has historically not paid dividends but is expected to appreciate over time. The trustee retains the M stock for 10 years (by prearrangement and subject to regular consultation with A), when A retires. At that time, when the stock is worth $34 million, the trustee begins to sell the stock at A's direction and pay A the unitrust amount, including the deficiency amount under the make-up provisions.

(1) Following the example, the manual states that an asset manipulation (*i.e.*, not selling stock of a non-income producing company in the early years and then investing in high yielding assets later on) intended to provide an economic benefit to the NIMCRUT's income beneficiary may be self-dealing if the beneficiary is a disqualified person. The manual asks how holding an asset off the market could adversely affect a charitable remainder interest. It answers the question by saying that it is possible that the M stock will not appreciate as fast as the general market. Having made this point, the manual goes on to say that in the end, it does not matter whether the charitable remainder trust ultimately is better off as a result of the investment strategy.

(2) This characterization as self-dealing may be overreaching by the IRS. The example in the manual of retaining the stock of a particular company "in consultation" with the grantor might be viewed as a "best case" example for the IRS. What if the trustee initially invested in a portfolio of low-yield marketable securities that was actively managed and later switched to a portfolio of higher-yielding assets? What if there is an independent trustee that makes these

decisions without consulting the beneficiary? In these situations, it would appear difficult for the IRS to challenge the trust.

6. Trust distributions from a unitrust may vary from year to year, depending on the value of the trust, while distributions from an annuity trust will not vary. The unitrust may be beneficial where the grantor seeks a measure of inflation protection for the noncharitable beneficiary. As the trust assets increase in value, the yearly payments also will increase. Offsetting this possible benefit is the fact that a charitable remainder unitrust generally will produce a smaller income tax charitable deduction than an annuity trust, because any increase in the income in an annuity trust will accrue entirely to the benefit of the charity. This is explored further in the following pages. In addition, a unitrust may be more difficult to administer, since the trust property must be revalued every year to calculate the distributable amount.

7. Previously, it was possible to submit a proposed trust instrument creating a charitable remainder annuity trust or unitrust to the IRS for approval. However, in Revenue Procedure 89-19 (1989-1 C.B. 841), the IRS announced that it will no longer ordinarily issue advance rulings as to whether such a trust is qualified under Code Section 664. Instead, the IRS has issued sample declarations of trust that meet all the requirements for a valid charitable remainder unitrust or annuity trust under the Code Revenue Procedures 2003-53, 2003-54, 2003-55, 2003-56, 2003-57, 2003-58, 2003-59 and 2003-60, 2003-2 C.B. 230 (August 4, 2003) (charitable remainder annuity trusts), and Revenue Procedures 2005-52, 2005-53, 2005-54, 2005-55, 2005-56, 2005-57, 2005-58, and 2005-59, 2005-34 I.R.B. 326 (August 19, 2005) (charitable remainder unitrusts). If the trust instrument substantially follows the sample trust instrument contained in the relevant Revenue Procedure and makes reference to the Revenue Procedure, the IRS will recognize the trust as meeting all of the requirements of a qualified charitable remainder annuity trust or unitrust, provided that the trust operates in a manner consistent with the terms of the trust instrument and is a valid trust under local law.

8. In Revenue Procedure 2005-24, 2005-16 I.R.B. 909 (March 30, 2005), the IRS required a spouse to waive his or her right of election in order for a charitable remainder trust to be valid.

   a. The IRS issued this revenue ruling in response to a perceived problem in states that have adopted the elective share provisions of the Uniform Probate Code which permit a surviving spouse to elect against the "augmented estate" consisting of both probate and non-probate assets. In some states, the assets of a charitable remainder trust might be included in the augmented estate and could be used to determine and satisfy the elective share amount.

Certain states provide that charitable remainder trust assets may be used to satisfy the elective share only after other property in the augmented estate has been exhausted. Other states exempt charitable remainder trusts completely.

b. The IRS believed that the possible use of assets of a charitable remainder trust to satisfy a surviving spouse's elective share ran afoul of the rules that the private beneficiaries of a charitable remainder trust may receive only the annuity payments or the unitrust payments. The mere existence of the right of election under applicable law, in the IRS's view, caused the trust to fail to qualify as a charitable remainder trust.

c. The IRS provided a safe harbor which caused the right of election to be disregarded. The procedure required that the spouse irrevocably waive the right of election to ensure that no part of the trust was used to satisfy the elective share. These waiver provisions only applied in situations in which a surviving spouse's right of election could be satisfied by assets in a charitable remainder trust.

d. The waiver had to be made upon the later of the following events:

- The creation of the trust;
- The date of the donor's marriage to the spouse;
- The date the donor first becomes domiciled or a resident in a jurisdiction whose law provides a right of election that can be satisfied from the assets of the trust; and
- The effective date of applicable state law creating a right of election.

e. In addition, a copy of the signed waiver must be provided to the trustee of the charitable remainder trust and the trustee must retain a copy in the official records of the trust for so long as the contents might be material in the administration of the trust. The waiver was to be completed within six months after the due date for the first form 5227, the Split Interest Trust Information Return, after the occurrence of the event causing the right of election to apply.

f. This revenue procedure was to be effective for all charitable remainder trusts created on or after June 28, 2005. Commentators had asserted that Rev. Proc. 2005-24 placed an undue burden on taxpayers and trustees seeking to comply with the safe harbor rule. Some commentators recommended withdrawal of the revenue procedure. Other commentators suggested alternative safe harbor rules. In response, the IRS, through Notice 2006-15, 2006 I.R.B. 501 (February 3, 2006), has indefinitely extended the June 28, 2005 grandfather date. Until further guidance is issued, the IRS will disregard the existence of such a right of election with respect to the validity of a charitable remainder trust, but only if the surviving spouse does not exercise the right of election.

D. Income Tax Effects

1. If the charitable remainder trust is created during life, the grantor receives an income tax charitable deduction when the trust is created equal to the present value of the remainder interest, subject to the percentage limitations previously discussed. If the property passes outright to the charitable remainder beneficiaries at the end of the income term, the contribution is treated as "to" rather than "for the use of" the charities. Therefore, if the charitable remainder beneficiaries are public charities, the percentage limitations for contributions to 50-percent-type organizations apply.

2. For an annuity trust the value of the remainder interest is computed by subtracting the present value of the annuity interest (determined under applicable Treasury Department tables) from the fair market value of the trust property. For a unitrust, the remainder interest is valued by reference to special tables contained in the income tax regulations (Treas. Reg. § 1.664-4) and IRS Publication 1458, Actuarial Tables, Beta Volume.

3. IRC § 7520 requires the IRS to issue monthly valuation tables which affect the valuation of charitable interests in split interest trusts. These tables use an interest rate assumption equal to 120 percent of the Federal midterm rate in effect under IRC § 1274(d)(1) for the month.

   a. Generally, the applicable table will be the one promulgated for the month in which a taxable transfer occurs. However, if an income, estate or gift tax charitable deduction is allowable for more than an insignificant part of the transferred property, as is the case with a charitable remainder trust, the taxpayer may elect to use either the current month's table or the table applying to either of the previous two months. In the case of charitable transfers, the same valuation table must be used to value all of the transferred interests, including non-charitable interests.

4. As mentioned previously, the value of a remainder interest in a unitrust, and hence the available income tax charitable deduction, will often be less than its value in a comparable annuity trust. The difference is significant at lower payout rates.

EXAMPLE: An individual creates a $100,000 charitable remainder unitrust that provides for annual payments to his wife equal to 6 percent of the fair market value of the trust property for 10 years, remainder to charity. Assume the applicable interest rate at the time is 8 percent. The value of the charitable remainder interest, and thus the income tax deduction available to the individual, is about $56,462 under the Treasury Department's unitrust tables. If the individual had created a charitable remainder annuity trust that paid his wife $6,000 a year for 10 years, the value of the charitable remainder, based on Table B of the Treasury Department's valuation tables, would have been $59,739.

5. As the payout rate increases, the disparity in value between the charitable interests in a unitrust and annuity trust decreases. At some point, which varies depending on the length of the annuity or unitrust term, there is a crossover and the unitrust produces the larger charitable deduction.

   a. For instance, if the payout rate for the unitrust in the previous example were 10 percent, the remainder interest would be worth $37,849. The remainder interest for a $100,000, 10-year annuity trust paying $10,000 annually would be $32,899.

   b. The unitrust produces the larger deduction at payout rates greater than the applicable interest rate because the high payout rate is treated as consuming some trust principal, which will then reduce the payout in the following year in a unitrust. By contrast, the payout in an annuity trust is fixed, so a high payout rate will use trust principal at an ever-increasing rate.

6. A charitable remainder trust is a tax-exempt entity. However, it must track its income because distributions from a charitable reminder trust carry out income which is taxed to the annuity or unitrust beneficiary. The payments from a charitable remainder trust during the noncharitable term will be taxed to the recipient in the following order:

   a. first, as ordinary income to the extent of the trust's ordinary income for the year and undistributed income for previous years;

   b. next, as capital gain to the extent of the trust's capital gain for the year and undistributed capital gain for previous years;

   c. next, as other income (including tax-exempt income) to the extent of such income of the trust for the year and such undistributed income for previous years; and

   d. finally, as a distribution of trust principal.

EXAMPLE: John transfers stock with a basis of $400,000 and a value of $1,000,000 to a charitable remainder annuity trust that will give him a 5%

($50,000) annuity for life. The trustee of the CRAT sells the stock and invests proceeds in marketable stocks and bonds. In year 1, the trust has dividend income of $11,000, interest income of $4,000, and $600,000 of capital gain. The CRAT does not pay any income tax. However, it allocates to John for tax purposes, the $11,000 of dividend income, the $4,000 of interest income, and $35,000 of capital gain income. At the end of the year, the CRAT has $565,000 of undistributed capital gain income.

7. The trust itself is expressly exempt from income tax even though it may have undistributed income, unless it has any "unrelated business taxable income" for the year, in which case the trust will incur an excise tax equal to 100% of the UBTI realized.

   a. Unrelated business taxable income is defined under Section 512 of the Internal Revenue Code, and in this context basically includes income from the operation by the trust of an active trade or business, and also debt-financed income. Therefore, generally speaking, the trust should neither incur debt nor accept property subject to debt.

   b. In Lela G. Newhall Unitrust v. Comm'r, 104 T.C. 236 (1995), aff'd 105 F.3d 482 (9th Cir. 1997), the trust had invested in a publicly traded limited partnership, which had unrelated business taxable income that flowed through to the partners. Under then-existing law, the court held that this caused the entire unitrust to be subject to income tax, even though the unitrust was a passive investor in the partnership.

8. Although charitable remainder trusts are exempt from income tax, they are required to file certain returns and reports with the IRS. All remainder trusts must file Form 5227, "Split-Interest Trust Information Return." In addition, if the trust is not required to distribute all of its income currently, it must file Form 1041-A, "Trust Accumulation of Charitable Amounts." The trust is required to file additional forms if it is liable for any excise taxes (Form 4720), or if it has unrelated business taxable income, in which case it is treated as a noncharitable trust that must file Form 1041.

E. Transfer Tax Effects

1. When a lifetime charitable remainder trust is created, the grantor makes a gift of the income interest (unless retained by the grantor) as well as the remainder interest, valued as described in the previous section. The gift of the income interest qualifies for the annual exclusion, since it is a present interest, and, if given to the spouse, for the unlimited marital deduction (IRC § 2523(g)). The gift of the remainder qualifies for the gift tax charitable deduction.

2. In the case of a testamentary trust, the decedent's estate will receive an estate tax charitable deduction for the value of the remainder interest, and a marital deduction for the income interest if the spouse is the sole noncharitable beneficiary (IRC § 2056(b)(8)).

3. Where the charitable remainder trust would provide for payment of the annuity or unitrust amount to the grantor's or decedent's spouse for life, a similar and less complicated alternative is a QTIP marital trust with remainder to charity. A QTIP trust can give the trustee a power to invade principal for the spouse's benefit (which is not permitted in a charitable remainder trust). The entire QTIP trust will potentially qualify for the unlimited marital deduction when created, and the spouse's estate will receive an estate tax charitable deduction for the value of the remaining trust assets at the spouse's death (IRC §§ 2044, 2055). Since the grantor will not receive an income tax charitable deduction when the trust is created, this approach is best used in a testamentary setting.

4. If the annuity or unitrust beneficiary of a charitable remainder is a grandchild or more remote descendant of the grantor (a "skip person"), then there may be generation-skipping transfer tax ("GST tax") ramifications to the trust.

   a. No GST tax is incurred upon creation of the trust because the charitable remainder beneficiary is treated as a non-skip person that has a present interest in the trust (IRC §§ 2651(e)(3), 2652(c)(1)(C)).

   b. However, distributions from the trust to the skip person are taxable distributions under the GST tax provisions. For example, if the trust is a charitable remainder annuity trust that pays $8,000 per year to the grantor's grandchild, each $8,000 distribution will be subject to the 55 percent GST tax, and this $4,400 tax must be paid by the grandchild (IRC § 2603(a)(2)).

   c. The grantor could allocate GST exemption to the trust to avoid the GST tax. To fully exempt the trust, the grantor must allocate GST exemption equal to the value of the noncharitable income interest in the trust (IRC § 2642(a)).

F. Planning Considerations with Gifts of Appreciated Property

1. If the grantor owns low-dividend-paying appreciated securities, the use of such securities to fund a charitable remainder trust results in a charitable deduction for the remainder interest based on fair market value of the securities transferred. The trust can then sell the securities without tax and invest in higher income securities, the income from which will fund a higher payout to the grantor than his previous dividend payouts. The

result is that the grantor has realized a benefit from the appreciation by using it (without paying a capital gain tax) to obtain a higher yield and also has obtained a charitable deduction for the remainder portion of the appreciation without paying a capital gain tax.

EXAMPLE: In 2018, an individual, age 70, transfers $100,000 of low-tax basis securities yielding 3 percent income annually to a charitable remainder annuity trust. The interest rate in the Treasury tables is 2.6%. The trust provides that a $5,000 annuity be paid to the individual for his life. The trustee of the trust sells the securities and invests in bonds yielding 5 percent income. The trust does not pay any tax on the capital gain resulting from the sale. The individual receives a $28,380 income tax deduction in the year of the transfer, which will save about $10,667 in income taxes (assuming a 37% tax rate). In addition, the individual receives over one and one-half times the income that he previously received from the securities.

2. The use of a charitable remainder trust allows the individual to retain all of the proceeds from the sale of the appreciated stock for reinvestment. If the individual had sold the stock directly, he would have only the after-tax proceeds available for investment.

Comparison of Sale of Zero Basis Securities to Use of Charitable Remainder Annuity Trust

Alternative	Capital Gains Tax on Sale	After Tax Amount Available for Investment	Income (5%)
Direct Sale of Securities	$20,000	$80,000	$4,000
Charitable Remainder Annuity Trust	$0	$100,000	$5,000

3. Ultimate Payment of Capital Gains Tax. Because of the tier system for the taxation of distributions to beneficiaries of charitable remainder trusts, any capital gains resulting from the sale may ultimately be distributed and taxed to the beneficiary. If the unitrust or annuity payment exceeds the trust’s ordinary income in a given year, capital gain will be carried out in an amount equal to that excess until all of the deferred gain has been fully distributed. Despite this, the beneficiary still is financially better off because the actual tax payments are deferred and spread over a many-year period.

4. Contract for Sale of Stock in Place Before Gift Made. Many donors begin thinking about a gift of appreciated assets to a charitable remainder trust

(or other charity) only after a contract for the sale of the appreciated assets is in place. The IRS will impute gain to the donor when such a transaction is already in place.

5. Donation and Redemption. Shareholders of a closely-held corporation often donate stock to a charity. The shareholder gets a charitable deduction. The corporation then redeems the stock from the charity. This allows corporate earnings and profits to be paid out without incurring dividend income. The redemption also will reduce the total number of outstanding shares, and thus may increase the value of stock held by younger generation family members (assuming that a more senior family member donated the stock to charity).

   a. In Palmer v. Comm'r, 62 T.C. 684 (1974), a donor had voting control of both a closely-held corporation and a private foundation. The donor contributed stock of the closely-held corporation to the foundation, and the corporation then redeemed the stock. The IRS argued that, in fact, the corporation redeemed the stock from the donor, and the donor then contributed the proceeds to the foundation. The Tax Court, however, respected the transaction, primarily on the basis that the foundation was not obliged to go through with the transaction.

   b. As a result of Palmer, the IRS issued Rev. Rul. 78-197, 1978-1 C.B. 83, which states that "the Service will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee [the charity] is legally bound or can be compelled by the corporation, to surrender the shares for redemption."

   c. In Blake v. Comm'r, 697 F.2d 473 (2d Cir. 1982), the Court of Appeals went further and said that a mere understanding between the donor and the charity is sufficient for the imputation of gain to the donor.

   d. These same rules should apply to arrangements between a donor and the trustee of a charitable remainder trust. Thus, it should be clear from the outset that there is no understanding or requirement between the donor and the trustee prior to the gift that the corporation will redeem the stock. In addition, the corporation should have complete discretion after the transaction as to whether it will redeem the stock from the trustee of the charitable remainder trust.

6. Liquidating Corporations. The test for imputing gain to a donor is whether the gift occurs before or after the liquidation plan becomes final.

If the liquidation plan is final prior to the gift of stock, then the gain realized upon liquidation of the corporation will be imputed to the donor.

a. Courts have taken differing views on when a liquidation plan became final. In two early cases, all necessary steps for liquidation had to be taken before the plan was final. In one case, the plan of liquidation was not final until consents of all shareholders were received. Winton v. Kelm, 122 F. Supp. 649 (D. Minn. 1954). In another, even though the liquidation plan was adopted, no gain was imputed to the donor since the gift was made before declaration of a liquidating dividend. Jacobs v. United States, 390 F.2d 877 (6th Cir. 1968).

b. Courts now apply a facts and circumstances test, which is less favorable to donors. For example:

(1) When the gift was made after the liquidation plan was formally adopted by the board of directors and the shareholders, the gain was imputed to the donor. Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972).

(2) When a board member made a charitable gift of stock after the board approved a plan of liquidation, but several weeks before shareholder approval, there was no imputation of gain, since shareholder approval was still necessary and, since the board members owned a minority of the shares outstanding, approval was uncertain. LTR 9117002 (Sept. 26, 1990).

7. Sale of donated property by charity to buyer with whom the donor had previously negotiated. An old case shows the problem that can arise. In this case, the donor negotiated with a prospective purchaser of stock in his closely held corporation. While negotiating, the donor told his attorney to prepare a charitable remainder trust. The donor transferred his stock to the charitable remainder trust. Two days later, the trustees (donor and his lawyer) sold the stock to the buyer with whom the donor had previously negotiated. The court found that the trust was not legally obligated to sell the stock. Therefore, the gain could not be imputed to the donor. Martin v. Machiz, 251 F. Supp. 381 (D. Md. 1966); see also Sheppard v. United States, 361 F.2d 972 (Ct. Cl. 1966). However, if the trust was legally obligated to sell the stock, then the gain would be imputed to the donor.

8. Avoid making cash gifts to charity. Many commentators recommend the use of long-term appreciated securities when a donor is considering a cash gift. The donor gives the securities to charity and uses the cash to buy the same securities on the open market. If the securities rise in value, the donor will have less taxable gain on a future sale because of the higher

basis. If the securities decline in value, the sale will produce a loss, instead of the gain that may have been produced on a sale of the original securities.

EXAMPLE: Donor has $100,000 of cash and $100,000 of stock with a basis of $0. If donor gives the cash to the charity, he receives income tax savings of $37,000 if he is in the 37% tax bracket. Two years later he sells the stock when it is worth $150,000. The capital gains tax on this sale is $30,000 ($150,000 gain x 20%). Thus, his net gain after paying tax is $120,000. If, instead, donor donates the stock to charity, he receives income tax savings of $37,000. He uses the $100,000 cash to replace the stock he has donated to charity. Two years later, he sells the stock for $150,000. The capital gains tax is $10,000 ($50,000 gain x 20%). Thus, the donor nets $140,000. This is $20,000 more than if the donor gave cash. In both cases, the donor receives the same income tax savings of $37,000.

9. Short Term Charitable Remainder Unitrust. Clients need advice on the possible pitfalls with certain charitable techniques. One example is the short term charitable remainder unitrust, which is quite appealing because of its perceived ability to allow a donor to avoid capital gains tax on highly appreciated assets and receive almost all the proceeds of sale (with only a minimal remainder going to charity). The IRS, however, once it learned of the technique, issued Notice 94-78 on July 21, 1994 and indicated that it would not permit the short term charitable remainder unitrust to reap the advantages its proponents perceived. Consequently, many donors, who created short term charitable remainder unitrusts not understanding all the ramifications, will be unhappy if the technique fails to work as advertised and they are taxed on the capital gains.

10. Forward Sales and Similar Transactions in Charitable Remainder Trusts are prohibited.

    a. The IRS has become more active in trying to eliminate perceived abuses in the charitable remainder trust area. In 1994, the IRS issued a Notice in which it stated that certain short-term charitable remainder trusts in which the donor retained a very large annuity percentage (which, when coupled with the timing of the sale of appreciated assets transferred to the trust, allowed the grantor to avoid virtually all capital gains inherent in the donated assets) would be considered an abusive transaction and ignored for income tax purposes. In 1997, Congress added certain provisions to the Code that codified the IRS position. Among other changes, the provisions capped the maximum payout in a charitable remainder trust at 50% and required a 10% minimum value for the remainder interest on the date of creation. It also authorized the Secretary of the Treasury to issue regulations that may be necessary or appropriate to carry out the purposes of the rules related to charitable remainder trusts.

b. On January 5, 2001, the IRS published regulations (1.643(a)-8) that eliminated some of the benefits of a charitable remainder trust in another situation, even though it would meet all of the statutory tests for a charitable remainder trust. An example of the transaction in question is as follows:

> A donor transfers highly appreciated assets to a charitable remainder trust that has a relatively short term and relatively high payout rate (although less than the 50% ceiling imposed under the Code). The trustee then borrows funds or enters into a prepaid forward contract or similar transaction, which allows the trustee to receive cash to make the annuity or unitrust payment without having to recognize gain upon a sale.

Since there is no current income to the trust, distributions to the donor are tax-free returns of principal, and the donor does not have to report any capital gains on his or her return. When the appreciated assets are sold and the transaction is closed out, capital gains would be recognized. However, at that time, the donor would be receiving a very small annuity from the trust, or the trust will have terminated and passed to the charitable beneficiary. In either case, very little capital gain is ever paid.

c. The regulations provide that a "mechanical and literal application of rules and regulations that would yield a result inconsistent with the purposes of the charitable remainder trust provisions will not be respected." They term the above transaction "abusive" and, therefore, an appropriate target of the regulatory power of the Treasury Department.

d. Under the regulations, to the extent that distribution from a charitable remainder trust is not characterized in the hands of the recipient as income under Code Section 664(b)(1), (2) and (3) and was made from an amount received by the trust that was neither a return of basis in any asset sold by the trust or attributable to a contribution of cash to the trust with respect to which a charitable deduction was allowed, the trust will be treated as having sold, in the year for which the distribution is due, a pro rata portion of the trust assets. In effect, although the loan or prepaid forward contract is not treated as a sale under ordinary income tax rules, these regulations treat entering into the transaction as a completed sale for purposes of determining the income tax results to the recipient of the charitable amount under the trust. So, for example, if a donor contributed low-basis stock to a charitable remainder trust and, in order to make the payment in year one, the trustee borrows funds and distributes them to the donor instead of selling any of the stock, the recipient would report ordinary income to the extent that the trust had earned any interest or dividends during the year. To the extent that there was insufficient interest and dividends to account for the full payment, the trust will have been deemed to have sold a proportionate amount of the trust assets, with a corresponding amount of capital gain being deemed to have occurred. The capital gain then will be treated as having been distributed to the beneficiary as well, up to the amount of the distribution. Any excess amount then will be treated as a tax-free return of principal. The trust will receive an adjustment in its basis for the amount of capital gain recognized as a result of the deemed sale.

e. The regulation is another example of Congress delegating its legislative authority to the IRS. Congress modified the charitable remainder trust law in 1997 to eliminate the abuses that it perceived at the time. However, even though this transaction clearly falls within the terms of the Code, the regulation eliminates its effectiveness. Such administrative legislation makes it difficult for planners to advise their clients on legal forms of tax planning.

G. Other Planning Considerations

1. A charitable remainder trust must designate one or more specific charitable remaindermen. However, the grantor of the trust can retain the power to name substitute charities or add one or more charities as remaindermen without jeopardizing the charitable deduction (Rev. Rul. 76-8, 1976-1 C.B. 179). The grantor also should be able to give this power to another. Alternatively, the grantor can give the income beneficiary of a charitable remainder trust a testamentary power of appointment to name qualified charitable remaindermen in place of those named in the instrument (Rev. Rul. 76-7, 1976-1 C.B. 179).

a. These powers add flexibility to the trust that may be attractive to the client, but they must be carefully drafted.

b. The remainder interest in a charitable remainder trust must be transferred to or for the use of a charitable organization described in Code Section 170(c), so any power to name new charities should require those charities to be Section 170(c) organizations.

c. In addition, if the grantor wants the percentage limitations for contributions to 50-percent-type organizations to apply for income tax purposes, any power to designate new remaindermen should be limited to public charities.

d. The grantor should not retain the power to change the charitable remaindermen if he is not the income beneficiary of the trust. By retaining the power until death, the grantor will cause the trust property to be included in his estate where it otherwise would not be. This not only may cause an increase in estate tax (because the estate will not receive a charitable deduction for the full value of the property if there is an income beneficiary still receiving payments) but also may affect the estate's ability to qualify for certain benefits, such as Section 303 redemptions or the Section 6166 election to pay estate tax in installments.

2. Charitable split-interest trusts are subject to most of the special operational restrictions applicable to private foundations. However, a charitable remainder trust is not subject to Code Section 4943 (excess business holdings) or Code Section 4944 (jeopardizing investments) if no charity has a current (as opposed to a remainder) interest in the trust (IRC Section 4947(b)). Thus, unlike a private foundation, a charitable remainder trust can be funded with stock in a closely-held company or other unusual investments.

3. The Treasury Department valuation tables applicable since May 1988 permit taxpayers to increase the available charitable deduction by timing the creation of a charitable remainder trust. There is added flexibility for charitable split-interest trusts (as opposed to transfers that do not have a charitable component) because the individual can select the interest rate for either the current month or the two previous months to value the interests.

4. For charitable remainder annuity trusts, the charitable remainder will be more valuable at higher interest rates. This occurs because the higher rates mean the trust is assumed for valuation purposes to earn more. If it is paying a fixed annuity, the higher earnings accrue to the benefit of the charitable remainder.

$100,000 Charitable Remainder Annuity Trust, $6,000 A
Value of Charitable Gift (Remainder Interest):

§ 7520 Tables

	10%	9%	8%	7%	6%	5%	4%	3%	2%
Life of Annuitant Age 50	$47,220	$42,640	$37,290	$30,990	$23,501	$14,507	$3,589*	0*	0*
10 yr. term	$63,132	$61,494	$59,739	$57,858	$55,840	$53,670	$51,335	$48,818	$46,104

* Does not meet 10% test.

5. For charitable remainder unitrusts, because the amount paid to the current beneficiary floats with the value of the trust assets, the change in the interest rates will have no effect (if the small impact dependent on the frequency and timing of the payments during the year is ignored).

$100,000 Charitable Remainder Unitrust, 6% Payout
Value of Charitable Gift (Remainder Interest):

§ 7520 Tables

	10%	9%	8%	7%	6%	5%	4%	3%	2%
Life of Annuitant Age 50	$21,840	$21,840	$21,840	$21,840	$21,840	$21,840	$21,840	$21,120	$20,949
10 yr. term	$54,677	$54,602	$54,521	$54,445	$54,364	$54,283	$54,202	$54,116	$54,035

H. Pooled Income Funds

1. A pooled income fund is defined in Code Section 642(c)(5) and is similar to a charitable remainder trust. Pooled income funds may be maintained by most public charities (but not by private foundations or some publicly supported charities). The pooled income fund receives gifts (usually either cash or marketable securities) from a number of donors, which are commingled and invested. Each donor, or the donor's designated beneficiary, receives a proportionate part of the fund's income based upon the value of the donor's contribution and the value of the fund upon the date of contribution. Upon the death of the income beneficiary (or, if more than one, upon the death of the surviving income beneficiary), the charity maintaining the fund becomes entitled to the donated property. Where a pooled income fund is available, it saves the donor the expense of preparing and administering a charitable remainder trust. This makes it very attractive where the donor is not contemplating a large gift.

2. The income the income beneficiary will receive from a pooled income fund is dependent on the yield of the fund assets. The character of distributions from the fund to the income beneficiary for income tax purposes is determined under normal trust rules, and thus will comprise proportionately the various types of income included in the fund's distributable net income.

3. The income tax charitable deduction resulting from the donor's transfer of property to the fund is the excess of the contributed property's fair market value over the present value of the retained income interest. This computation is governed by regulations (Treas. Reg. § 1.642(c)-6), and depends both on the donor's age and the yield of the fund. If the income interest is given to another, the donor will be treated as making a present value gift of that interest for gift tax purposes.

V. **Investments by Charitable Remainder Trusts**

A. Tax-Exempt Securities

1. The IRS has continued to argue that a contribution of appreciated securities to a charitable remainder trust that sells the appreciated securities and invests in tax-exempt municipal bonds may result in attribution of the gain on the sale to the donor in the year of the sale. (See Rev. Rul. 60-370, 1960-2 C.B. 203.) This tax treatment may occur when the trustee is under an obligation, either express or implied, to sell the appreciated property.

2. The annuity or unitrust payments of a charitable remainder trust are taxed to the income beneficiary first as ordinary income, second as capital gains, next as other income, including tax-exempt income, and finally as a distribution of principal. Treas. Reg. § 1.664-1(d). This tier approach ensures that capital gain realized by the trust must be recognized by the beneficiary as distributions are made before any tax-exempt income is deemed distributed to the beneficiary. This eliminates the abuse at which the ruling was aimed.

3. The IRS has admitted in an information letter that a charitable remainder trust funded with appreciated securities may sell those securities and invest the proceeds in tax-free municipal bonds. See Weilthorn, "Tax Planning for the Charitable Section," New York Law Journal Seminar at 33-34 (1980).

4. A new concern now exists at the state level. The Pennsylvania Attorney General, acting in place of the remaindermen of two charitable remainder trusts, brought surcharge actions against the trustees of charitable remainder trusts. The Attorney General argued that investment in lower-yielding tax-exempt bonds impermissibly favored the income beneficiaries

over the remaindermen, because the income beneficiaries obtained a higher income while the principal of the trust increased at a lower rate. The Attorney General lost in one case, Estate of Feinstein, 527 A. 2d 1034 (Pa. Superior Ct. 1987), but won in the other, Estate of McCahan, 564 A. 2d 1011 (Pa. Superior Ct. 1989).

B. Zero Coupon Bonds

1. Some commentators believe that zero coupon bonds are a good investment for the income only charitable remainder unitrust (often used in retirement planning). This is because zero coupon bonds can be purchased that will not mature until after the retirement of the donor.

   EXAMPLE: Donor, age 55, contributes $50,000 to an income only charitable remainder unitrust with a make-up provision paying the lesser of 5% of the fair market value of the assets or net income. The trust purchases a 9½% zero coupon bond with a ten-year term for $50,000. At the end of the ten-year term, when the bond matures, the trust will have $123,900 ($50,000 principal and $73,900 accrued income). The payout deficit is $38,900. If, at the end of the ten-year period, the payout deficit is made up, the trust will still have $85,000 after satisfaction of the payout deficit. This can be invested to generate significant income over the remaining term of the trust. If there is no make-up provision, the entire $123,900 could remain in trust to generate future income. In either case, no income is paid to the donor until age 65, when the donor is expected to retire and need the income because he will no longer receive a salary or other compensation.

2. Zero coupon bonds are purchased at a steep discount from face value and do not pay interest. Instead, individual bondholders recognize income based on the annual increase in the value of the bonds. This tax treatment will not work for an income only charitable remainder unitrust, because the trust would be deemed to receive income each year and would be obligated to make payments to the beneficiary even though no liquid assets were available.

3. For a charitable remainder unitrust funded with zero coupon bonds to work as desired, the unitrust must be drafted to accomplish two results:

   a. Deferral of recognition of income from the zero coupon bond until the bond matures or is disposed of.

   b. Allocation of the discount element of the proceeds of the redemption of the zero coupon bond to trust income. This allows that part of the proceeds to be paid to the beneficiary to make up for past deficiencies.

4. The IRS has ruled that so long as the trust provision does not violate local law, the accruing value may be excluded from income until the bond matures or is otherwise disposed of. LTR 8604027 (Sept. 24, 1985).

5. Moreover, the discount element upon maturity or redemption of the zero coupon bond can be allocated to income and not to principal as long as local law is not violated. In Private Letter Ruling 9018015 (Jan. 31, 1990), an income only charitable remainder unitrust was drafted allocating the discount element to income upon maturity. Under the governing local law, the discount element was normally allocated to principal. However, local law also permitted allocation of the discount element to income.

C. Insurance

1. Insurance on the life of a donor is a permissible asset of a charitable remainder unitrust. LTR 7928014 (Apr. 10, 1979). Often, insurance is used to fund a charitable remainder trust for the donor's spouse or children when the donor lacks sufficient liquid assets to fund the trust. A policy on the life of the donor or on the lives of the donor and the donor's spouse may be used.

2. Normally, an income only unitrust is used.

   a. The use of a unitrust (as opposed to an annuity trust) permits additional contributions to the trust, which are used to pay the premiums.

   b. An income only unitrust avoids the need to make payouts from the trust when there are no assets in the trust other than the policy.

3. If the policy is on the life of the donor, then during the life of the donor, the donor continues to pay the premiums on the policy by making regular contributions to the unitrust. The donor receives a charitable income deduction for the value of the remainder interest with respect to each premium payment.

4. Upon the death of the donor, the policy matures and the trust is funded with the proceeds of the policy, providing income for the designated beneficiary.

   a. Single life policy. The beneficiary is normally the spouse, otherwise the children of the donor.

   b. Joint life policy. The beneficiaries are often the children of the donor.

5. If the donor wants to increase the income payable upon maturity of the policy, a make-up provision could be included. This permits the trustee to

distribute excess income over the unitrust amount to make up for payments not made prior to the death of the donor and the maturity of the policy

6. Considerations.

   a. The trustee must be free to dispose of the insurance policy at any time to meet the requirement that a charitable remainder trust cannot contain any provision that would prevent the trustee from earning a reasonable rate of return. Treas. Reg. § 1.664-1(a)(3).

   b. A policy should not be contributed to a charitable remainder trust if the donor has borrowed against it. This is necessary to avoid violating the self-dealing rules of IRC § 4941 to which charitable remainder trusts are subject.

   c. If the trust has other income, the trustee should not borrow against the policy. If the borrowed funds are invested, those investments are considered debt-financed property (IRC § 514), and income from those investments will be taxed as unrelated business taxable income. IRC § 664(c). Borrowing against the policy can be done if the trust has no income. Although the debt is acquisition indebtedness, there is no income to tax.

D. Interests in S Corporations, LLCs or Partnerships

1. The liberalization of the rules governing permissible shareholders in an S corporation did not open the door for charitable remainder trusts to hold S corporation stock. Certain tax-exempt entities became permissible S corporation shareholders for tax years beginning on or after January 1, 1998, but a charitable remainder trust was not among them (see IRC § 1361(e)(1)(A)).

2. A charitable remainder trust can hold interests in an LLC or partnership. However, as was demonstrated in Leila G. Newhall Unitrust v. Comm'r, 104 T.C. 236 (1995), aff'd, 105 F.3d 482 (9th Cir. 1997), the grantor and/or trustee must be certain that the LLC or partnership holds only passive investment assets, and no assets that generate unrelated business taxable income. If the LLC or partnership has such income, it will be attributed to the charitable remainder trust, and the trust will be subject to the UBTI tax.

3. In addition, there is a danger that the investment could violate the self-dealing rules. Any sort of loan from or partial liquidating distribution to the charitable remainder trust would be self-dealing (IRC § 4941(d)). Although the IRS has issued some favorable private rulings, there is a concern that a charitable entity's investment in a family controlled partnership or LLC (particularly as a general partner or member-manager)

is per se self-dealing (see Letter Rulings 9448047 (Dec. 2, 1994); 9114025 (April 5, 1991)).

E. Retirement Benefits

1. Retirement benefits are potentially subject to both estate and income tax upon the death of the participant. The designated beneficiary of the benefits will be subject to income tax on distributions from the retirement account after the death of the participant. The benefits also are subject to estate tax unless they are paid to a surviving spouse. In that case, they will be subject to tax at the spouse's subsequent death.

2. Because of this excessive tax burden, retirement benefits are viewed as good assets to leave to charity. Even if an individual is not charitably inclined, having a charitable remainder trust as the beneficiary of retirement benefits can minimize the tax cost and ultimately leave the family in a better financial position. The estate will be entitled to a charitable deduction for the value of the interest that will pass to charity. The trust will be tax-exempt, so it will not owe income tax upon receipt of the benefits. (Note, however, that any excise tax on excess accumulations will still be due.)

3. The payment of retirement benefits to a charitable remainder trust often makes the most sense when the participant in the plan is widowed or not married, so the beneficiary otherwise would bear the full brunt of the income tax and estate tax. If the beneficiary is a child or other family member in a lower generation and he or she lives to his or her normal life expectancy, it is likely that the increased amount that can be paid annually to the beneficiary from the charitable remainder trust as a result of the tax savings will offset the "loss" of the property to charity at the beneficiary's death.

4. Designating a Charitable Entity as Beneficiary.

   a. If a charity is the designated beneficiary of a qualified plan or IRA, it can collect the proceeds upon the participant's death without incurring income tax, by virtue of the charity's tax-exempt status. From an income tax standpoint, the benefit to the decedent's estate and beneficiaries is similar to the benefit obtained from donating appreciated marketable securities to a charity—the charitable gift is satisfied in part with unrealized taxable income, so the federal government in effect pays for part of the contribution.

   EXAMPLE: Client has an estate consisting of a $500,000 life insurance policy and $500,000 in a qualified plan. He wants to leave half of his estate to his spouse and half to charity. Assume he designates his wife as beneficiary of the qualified plan, and she takes a distribution of the entire amount. Using a 40% income tax rate, she has $300,000 left after taxes. Assume instead that he designates the charity as beneficiary of plan, and leaves the life insurance to his wife. The charity receives the plan benefits and pays no income tax. His wife receives $500,000 in insurance proceeds.

b. In addition, the decedent's estate will receive an estate tax charitable deduction for the value of the proceeds given to charity.

c. A charitable gift of qualified plan or IRA proceeds should not be accomplished by using the account proceeds to satisfy a pecuniary bequest to charity in the will or revocable trust. As is the case with other kinds of income in respect of decedent, use of a qualified plan or IRA to fund a pecuniary bequest will cause immediate recognition of income.

(1) Instead, the charity should be named as the designated beneficiary or one of the designated beneficiaries of the plan or IRA.

(2) The practitioner should make sure the client is aware that the plan or IRA designated to pass to charity could be depleted if the client lives past the RBD and must withdraw funds. If the client wants to be sure that the charity receives at least a specified amount, then a contingent make-up gift can be added to the client's estate plan.

EXAMPLE: Client has an IRA worth $100,000, which he wants to leave to his alma mater. He wants to make sure that the college receives at least $75,000, to fulfill a capital campaign pledge he made. Client designates the college as beneficiary of the IRA, and adds a bequest to his will that leaves to the college the sum of $75,000, reduced (but not below zero) by the value at his death of any IRA on which the college is the designated beneficiary.

(3) The client also may be concerned that the charity will receive too much if the qualified plan or IRA grows in value. In this case, the client could create a separate IRA account with the amount of property he wants the charity to receive. Each year, if the separate account has excess funds, he can direct an account-to-account transfer of those funds to his other IRA account.

EXAMPLE: Client has a $1,000,000 IRA and wants to use $250,000 of it for a testamentary gift to a local hospital. He creates a new IRA account with $250,000. At the end of each year, if the account exceeds $250,000, he directs that the excess be transferred back to his original IRA account.

A client doing this should be sure to have a power of attorney in place which would direct his agent to make these transfers if the client becomes disabled.

d. One of the entities that can be designated as beneficiary of a qualified plan or IRA is a charitable remainder trust (CRT). An individual could designate a CRT as beneficiary in order to permit a spouse or other relative to receive benefits from the retirement account while still benefiting charity.

(1) The CRT itself is a tax-exempt entity. It will not pay income tax upon collecting the qualified plan or IRA benefits. IRC § 664. The annuity or unitrust distributions to the CRT beneficiary will carry out the taxable income represented by the benefits, but possibly on a more favorable basis than if the benefits were payable directly to the beneficiary.

(2) The individual's estate also will receive an estate tax deduction for the charitable portion of the CRT.

e. If the client is considering a CRT for a spouse, he also should consider the alternative of designating a QTIP trust as beneficiary, with the remainder interest of the trust passing to charity. There are several differences between the two options:

(1) The QTIP trust provides the opportunity to make additional funds available to the spouse, through principal distributions. The annual distribution is not a fixed amount, as it is in a CRT.

(2) On the other hand, greater distributions from a marital trust will mean that more income tax will be incurred as benefits are distributed.

(3) As mentioned above, when a charitable entity is designated as beneficiary, the participant can use only his life expectancy in determining the required minimum distributions. Under one interpretation of the proposed regulations, a QTIP trust with a charity as vested remainderman (i.e., the spouse does not have a

testamentary power of appointment) would be treated as a trust that has a charity as a beneficiary, so that the use of a second life expectancy still would not be available. (See Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-6, E-5). Many commentators are hopeful, however, that the final regulations will clearly permit an individual to use a joint and survivor life expectancy with his spouse if a QTIP trust with a charitable remainderman is the designated beneficiary. In any event, if the individual gives his spouse a limited power of appointment over the QTIP trust, he should be able to use the joint and survivor life expectancy.

f. In most cases, it is not possible to avoid income tax on lifetime distributions from a qualified plan or IRA by "donating" the plan to a charity. The donation would be treated as a distribution taxable to the participant, followed by a charitable gift. However, clients who are considering making substantial withdrawals from a plan or IRA (for example, to keep the account below the level at which the excise tax could start to apply) should consider creating a CRT in the year of the withdrawal to provide a charitable deduction that will help offset the additional taxable income.

g. The 2006 Pension Protection Act provided an exclusion from gross income for certain otherwise taxable IRA distributions from a traditional or Roth IRA in the case of qualified charitable distributions. Qualified charitable distributions are any distributions up to $100,000 per year from an IRA made directly by the IRA trustee to a qualified charitable organization if the IRA owner has attained age 70½. The exclusion is not available for a distribution to fund a charitable remainder trust, pooled income fund, or charitable gift annuity. A qualified charitable organization is one described in section 170(b)(1)(A) other than a supporting organization or a donor-advised fund. Contributions to private foundations do not qualify for the exclusion. The IRA owner is not entitled to an income tax charitable deduction under section 170 for any amount excluded from gross income under this provision. This exclusion has now been made permanent under the Protecting Americans from Tax Hikes (PATH) Act of 2015.

VI. Bargain Sales

A. A bargain sale is a sale of property to a charity at less than fair market value. The excess of fair market value over the sale price represents a charitable contribution.

B. The taxpayer must allocate his cost basis in the property between the portion of the property that is "sold" and the portion that is "donated" according to the relative fair market value of each. If the property has appreciated in value since the taxpayer acquired it, he will realize capital gain on the appreciation allocable to the portion that is "sold" (IRC § 1011(b)). As a result, the taxpayer may owe capital gains tax from the bargain sale, even though the sale price is equal to or less than his cost basis in the property.

EXAMPLE: An individual owns 100 shares of appreciated stock with a basis of $4,000 and a fair market value of $10,000. The individual has held the stock for more than one year. Wishing to make a $6,000 donation to his favorite qualified charity, he sells that stock to the charity for $4,000. The amount of the individual's basis allocable to the "sale" portion of the bargain sale is $1,600 ($4,000 divided by $10,000, times $4,000). As a result, the individual will recognize long-term capital gain of $2,400 ($4,000 minus $1,600), and will be entitled to a charitable deduction of $6,000.

1. Assuming that the individual in the preceding example is in a 28 percent income tax bracket, had he instead sold the stock on the market for $10,000 and then donated the realized gain ($6,000) to charity, he would be $720 worse off than with the bargain sale. This is because, through the bargain sale, $3,600 of potential capital gain is avoided, which saves $720 in tax ($3,600 x .20).

2. If property used in a bargain sale is short-term capital gain property, the donor cannot deduct the short-term appreciation as a charitable contribution, and need not make an allocation of tax basis in the property (IRC § 170(e)(1); Treas. Reg. § 1.170A-4). In the preceding example, if the individual had held the 100 shares of stock for less than one year, and sold the property to the charity at a price equal to his tax basis, the net result would be no taxable gain and no charitable deduction.

VII. Transfer of Debt-Encumbered Assets to a Charitable Remainder Trust

There are three potential problems with the transfer of debt-encumbered assets, such as mortgaged property, to a charitable remainder trust:

A. Unrelated Business Taxable Income ("UBTI"). Unless the donor has held property for more than five years and the debt on the property has existed for more than five years, any transfer of debt-encumbered property to a charitable remainder trust will result in UBTI. IRC § 514(c)(2)(B). (A transfer of debt-encumbered property that has been held by the donor for at least five years prior to the transfer and upon which the debt has existed for at least five years will not subject the trust to unrelated business income tax for a period of ten years after the transfer to the charitable remainder trust.) Under the Tax Relief and Health Care Act of 2006, a charitable remainder trust that has UBTI in a taxable year beginning after December 31, 2006 will be subject to 100% excise tax on the UBTI generated by the trust. However, the other income generated by the charitable remainder trust will not be subject to income tax. The 100% excise tax is a harsh penalty so charitable remainder trusts should not contain assets that generate UBTI, except in insignificant amounts.

B. Application of the Bargain Sale Rules

1. When a donor transfers debt-encumbered or mortgaged property to a charitable remainder trust, the transaction is subject to the bargain sale rules of Section 1011(b) whether or not the trust, as a result of the transfer, becomes liable to make payments on the mortgage and the donor is relieved of the obligation. Treas. Reg. § 1.1011-2(a)(3).

   a. The debt portion of donated property will be treated as a sale.

   b. The unencumbered portion of property will be treated as a gift.

   c. The donor will have to treat the sale portion as income received and pay capital gains tax on the difference between the value of the sale portion and the prorated adjusted basis in the property.

2. If the donor is not an income beneficiary of the trust, then the donor should be treated as receiving the full amount of indebtedness. If the donor is an income beneficiary of the trust, the sale proceeds received by the donor arguably should be limited to the portion of the liability transferred to third parties (other income beneficiaries and charitable remaindermen). The portion of liability allocable to the donor's retained interest arguably has not been transferred so as to require recognition of gain. Thus, the donor could be considered the owner of a portion of the trust under the grantor trust rules.

C. Grantor Trust Rules

1. Under Treas. Reg. § 1.664-1(a)(4), a charitable remainder trust is deemed created when neither the grantor nor any other person is treated as the owner of the entire trust under the grantor trust rules. (The fact that the grantor or other income beneficiary would be treated as owner solely because of his income interest will not prevent the trust from being deemed to be created.)

2. Under Treas. Reg. § 1.677(a)-1(d), a grantor may be treated as owner of a trust to the extent that income may be applied to discharge a legal obligation of the donor. This regulation will cause the charitable remainder trust to fail unless the donor can show that the transfer has relieved the donor of any obligation on the mortgage.

3. If the donor recognizes the full amount of the indebtedness under the bargain sale rules, the donor may be able to argue that the grantor trust rules do not apply since the indebtedness of the donor has been discharged. However, Private Letter Ruling 9015049 (Jan. 16, 1990) has

held that a proposed transfer of mortgaged property to a charitable remainder unitrust would disqualify the trust because the trust became obligated on the donor's obligation. However, this ruling did not address the issue of the discharge of the obligation under the bargain sale rules.

VIII. Use of Options To Avoid Problems with Transfers of Debt-Encumbered Property

A. Instead of donating debt-encumbered property to a charitable remainder trust, the donor may wish to consider transferring an option to purchase the property to the trust. However, as discussed in paragraph F of this Section, the IRS has recently attacked the use of options.

B. The use of an option is usually a three-step transaction.

1. The owner of real estate and the trustee of the charitable remainder trust enter into an option agreement. The trustee may exercise the option within a specified time at a specific price.

2. The trustee of the charitable remainder trust sells the option to a third party. The price at which the option is sold usually will be the difference between the fair market value of the property and the price of the option.

3. The party exercises the option to purchase the property for the price stated in the option, and legal title is conveyed to the buyer from the owner.

EXAMPLE: Anne owns real estate with a fair market value of $250,000 and a $40,000 mortgage. Anne gives Bill, the trustee of a charitable remainder trust, an option to purchase the property at a cost of $50,000. Bill sells the option to Carla, a third party, for $200,000 (the difference between the fair market value of $250,000 and the option agreement price of $50,000). Carla buys the property from Anne for $50,000. Anne uses the $50,000 to pay off debt on the property and sales costs. The charitable remainder trust receives $200,000. The income produced by the $200,000 is distributed to Anne as income beneficiary of the charitable remainder trust.

C. Tax consequences

1. Gift tax. The value of the option transferred to the charitable remainder trust is a tax-free gift equal to the value of the option set forth in the option agreement. The gift is complete only when the option is exercised. If the charitable remainder trust or another charity never exercises the option, the gift is incomplete. Rev. Rul. 67-178, 1967-1 C.B. 64 (potential rights to reacquire property made gift incomplete for gift tax purposes).

2. Income tax. The donor gets an income tax deduction upon the exercise of the option by the charitable remainder trust. The value of the deduction is the present value of the remainder interest that will be received by charity.

An income tax deduction is also available upon the exercise of the option by another charity to which the trust has sold the option. See, e.g., LTR 9335056 (June 10, 1993). In that case, the donor receives a deduction for the difference between the fair market value of the property at the time the option is exercised and the option price. Although some commentators have suggested that the donor receives an income tax deduction when the trustee sells the option to a third party, this tax result is presently unclear.

3. Capital gains tax can be reduced as a result of allocating the donor's basis between the portion of the property received by the charitable remainder trust and the portion that represents a sale by the donor to the third party buyer.

EXAMPLE: Alice owns a house with a fair market value of $150,000 and a basis of $50,000. Alice gives the XYZ charitable remainder trust an option to purchase the property at a price of $60,000. The XYZ trust sells the option to Barbara for $90,000. Barbara then exercises the option to purchase the house for $60,000 from Alice. The basis is prorated between Alice and the XYZ trust. Alice's share of the basis will be determined under the following formula:

$$\textit{basis x}\,\frac{\textit{option price}}{\textit{total value}} = \$50{,}000\ \textit{x}\,\frac{\$60{,}000}{\$150{,}000} = \$20{,}000$$

The taxable capital gain on this is the difference between the option price and Alice's share of the basis ($60,000 – $20,000, or $40,000). The capital gains allocated to the XYZ trust of $60,000 ($90,000 (price) – $30,000 (share of basis)) will avoid capital gains tax so long as the sale from the charitable remainder trust was not prearranged and was not subject to any condition or stipulation.

D. Factors in determining the option price

1. Need of owner for cash (1) to pay off mortgage on property and (2) to pay sales costs and other transaction costs (such as the cost of creating and implementing the charitable remainder trust).

2. The amount of capital gains tax on the transaction that must be paid by the owner, if any. If the donor is over age 55, the one time exclusion for capital gains under IRC § 121 will be available to minimize or avoid the gain.

3. The length of the option period.

E. Avoiding environmental liability problems for the trustee

1. Under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund") trustees face possible personal liability for the costs of cleaning up environmental contamination if they are found to be a responsible party under the provisions of CERCLA. Normally, this liability will be imposed because the trustee is considered to be an "owner" or "operator" of property on which environmental contamination has occurred. In order to avoid personal liability, trustees of charitable remainder trusts do not wish to own property which is or could be contaminated. However, if contaminated real property is transferred to the charitable remainder trust, the trustee would become the owner of the property and could face personal liability under CERCLA.

2. One way for the trustee possibly to avoid liability under CERCLA is for the donor to give the trustee an option to purchase the property. The trustee then sells the option to a third party purchaser, who, in turn, exercises the option to buy the property from the donor. Since title passes directly from the donor to the third party, the trustee should not be considered the "owner" for CERCLA purposes. Also, since the donor will control the use of the property until the third party purchases the option from the trustee of the charitable remainder trust and exercises it, the trustee should not be considered an "operator" for purposes of CERCLA.

F. IRS Attack on Use of Options

1. In Letter Ruling 9240017, the IRS had approved the gift of an option to a charitable remainder trust. The donor in that ruling had transferred an assignable option to purchase unencumbered real property to a charitable remainder unitrust. The IRS had ruled that the donor was not entitled to an income tax charitable deduction when the option was granted or when the trust sold the option. A charitable deduction was allowable only when the donor sold the property to the charitable remainder trust or to another charitable organization. The charitable deduction allowed would be the difference between the fair market value of the property at the time the option was exercised and the option price. In Letter Ruling 9417005, the IRS withdrew Letter Ruling 9240017 and announced that it was reconsidering the issues raised in that ruling.

2. In Letter Ruling 9501004, the IRS ruled that the gift of an option to a charitable remainder trust disqualified the trust as a charitable remainder trust under Section 664. To reach this result, the IRS first ruled that a gift of an option is not complete until the option is exercised, and, therefore, will not qualify for the charitable deduction until that time. However, each transfer to a charitable remainder trust must qualify for the charitable deduction. Because no income tax or gift tax charitable deduction is

allowable for the transfer of an option to a charitable remainder trust, the trust ceases to qualify as a charitable remainder trust upon the transfer.

3. Despite this ruling, the gift of an option should still be viable for gifts to private foundations and public charities, since those charitable organizations are not required to meet the requirements for charitable remainder trusts under Section 664.

IX. **Wealth Replacement Plan**

A. Description of Technique. The wealth replacement plan is designed for an individual who would like to avoid capital gains on low-yielding, highly-appreciated assets, obtain an income tax charitable deduction, and still ensure that his descendants (or other non-charitable beneficiaries) will take at least as much as the current value of the assets. The wealth replacement plan utilizes a charitable remainder trust and either (i) outright annual gifts to heirs, which are used to purchase insurance and pay premiums, or (ii) an irrevocable life insurance trust. In either alternative, the life insurance proceeds pass to the settlor's descendants free of any transfer tax, thus "replacing" the value of the assets donated to charity.

B. Charitable Remainder Trust. The charitable remainder trust, which may be either an annuity trust or a unitrust, is best funded with highly-appreciated, low-yield assets. The settlor's expectation is that the property will be sold by the trustee for higher-yield property. The settlor names himself the life beneficiary of the trust. By having the charitable trust sell the assets, the settlor should avoid any capital gains tax on the sale.

C. Outright Gift Alternative. This plan utilizes a charitable remainder trust and the purchase of an insurance policy by the heirs.

EXAMPLE: David and Laura, husband and wife, ages 55 and 54, have two daughters, ages 30 and 28. David and Laura own a large amount of stock in XYZ Company. The stock, which was acquired 30 years ago, has a basis of $1 per share and a fair market value of $100 per share. The stock presently pays a dividend of 75¢ per share (less than a 1% return). David and Laura wish to make a gift to the University of Virginia, but they are concerned about having sufficient income during retirement and providing a substantial inheritance to their two daughters.

In order to accomplish their goals, David and Laura fund a $1,000,000 charitable remainder unitrust with 10,000 shares of XYZ stock with Your Bank as trustee and name the University of Virginia as the charitable remainderman. The trustee sells the XYZ stock and pays no capital gains tax. If David and Laura had sold the stock, the capital gains tax would have been $198,000. In addition, David and Laura receive an income tax deduction of approximately $300,000 (the value of the remainder interest), which produces tax savings of $111,000 (assuming they are in the top 37% tax bracket. If the unitrust amount is 5%, David and Laura will enjoy an income of $50,000 per year, as opposed to their present income of $7,500 per year from the XYZ stock.

At the same time, the daughters purchase a second-to-die life insurance policy on the lives of their parents. The policy has a face value of $1,000,000 and the annual premium is $10,000. Each year, using part of the income from the unitrust, David and Laura make annual exclusion gifts to their two daughters, which their daughters, in turn, use to pay the annual premium on the life insurance. Since neither David nor Laura has any ownership interest in the second-to-die policy, the proceeds escape transfer tax at the survivor's death.

Through use of the plan, David and Laura are able to increase their income, benefit the University of Virginia, and not deprive their children of their inheritance.

D. Irrevocable Life Insurance Trust Alternative

1. The plan employs two trusts - a charitable remainder trust and a non-charitable irrevocable life insurance trust. In this case, the trustee becomes the owner through the purchase or assignment by the settlor of an insurance policy on the settlor's life with death benefits equal to or greater than the value of the appreciated securities transferred to the charitable remainder trust. The trustee will receive the insurance proceeds at the insured's death. The terms of the irrevocable trust can be quite flexible and can ensure that income and principal are available to a surviving spouse or to descendants for almost any purpose that the insured specifies.

2. Advantages of gift in trust

   a. The trust provides a vehicle for managing the proceeds for the beneficiaries.

   b. If the spouse is to be a beneficiary of the trust, the trust can be structured so as to avoid inclusion of the proceeds not only in the insured's estate but in the spouse's estate as well.

   c. If the spouse or descendants predecease the insured, the value of the policy will not be included in the spouse's or descendant's estate.

   d. If the insurance proceeds may be needed by the estate to pay death taxes and administration expenses, the trust can specifically permit the trustee to purchase assets from the estate or to loan funds to the estate.

E. Income Tax Effects

1. The settlor receives an income tax charitable deduction when the charitable remainder trust is created equal to the present value of the charitable remainder interest as determined from the Treasury Department tables.

2. By donating the assets to charity rather than selling them outright, the settlor avoids paying capital gains tax. If the trustee sells the property after it is transferred to the charitable remainder trust, there will be no capital gains tax. The settlor, however, must be aware of Revenue Ruling 60-370, 1960-2 C.B. 203. According to this ruling, if the trustee is under an express or implied obligation to sell or exchange the transferred property and the sale takes place, the settlor is deemed to have sold the property himself and given the trustee the proceeds. The gain from the sale is imputed to the donor and includable in his gross income. Thus, the settlor should impose no requirements on the trustee regarding the sale of the securities.

3. The income distributed from the charitable remainder trust will be taxed to the settlor under the income tax rules generally applicable to such trusts.

F. Transfer Tax Effects

1. The settlor will need to make an annual gift to the life insurance trust or directly to his descendants to provide for the payment of the premiums. If the trust gives the beneficiaries Crummey powers, the gift will be a present interest and will qualify for the gift tax annual exclusion. As noted above, the amount of the premium should not exceed the settlor’s total annual exclusion allowance.

2. The gift of the remainder interest in the charitable remainder trust qualifies for the gift tax charitable deduction.

3. At the settlor’s death, the life insurance proceeds will pass to or be held in trust for the beneficiaries free of estate tax if the settlor has retained no incidents of ownership in the policy.

G. Limitations on the Plan

1. The plan is a risk-cutting device: while it ensures that the individual’s descendants will receive the original value of the property tax-free, it does not provide for appreciation. The settlor or his heirs may wish to provide for this by purchasing life insurance with death benefits that are greater than the value of the property transferred to the charitable remainder trust.

2. As noted above, the plan may have certain technical requirements that necessitate expert legal advice. For example, the irrevocable life

insurance trust must contain Crummey powers to ensure that the beneficiaries receive a present interest in the property. The irrevocable life insurance trust must be carefully drafted to avoid inclusion of the entire policy amount in the settlor's estate.

3. This plan will only work with individuals who are able to purchase insurance on their lives. Thus, it may not be appropriate for older individuals who are either uninsurable or for whom the costs of insurance may be prohibitive.

H. Alternatives. When examining a wealth replacement plan, the donor must consider whether the purchase of insurance is desirable. If an individual or couple is younger and can be expected to survive for a reasonable number of years, the excess income from a charitable remainder trust can be expected to be invested and grow. At some point in time, if the income is not consumed, the amount of property held outside the trust will exceed the property held inside the trust. This outside property can pass to the children, replacing the property in the trust.

X. IRS Review of Charitable Remainder Trusts

Many estate planning professionals have been using charitable remainder unitrusts, particularly net income, make-up charitable remainder unitrusts (NIMCRUTs), to try to create special benefits for the non-charitable beneficiaries. The IRS issued final regulations several years ago in an attempt to curb some uses of unitrusts that it views as inconsistent with their exclusive function as charitable remainder trusts. (Final Regs. §§ 1.664-1 to 3 and § 25.2702-1)

A. CRUTs with nonmarketable assets. The IRS has previously ruled privately that a CRUT that contains nonmarketable assets must have an independent trustee determine the annual value of those assets for purposes of calculating the unitrust amount. The IRS's concern is that the grantor or a beneficiary has too great a personal interest in that valuation, since it determines the annual trust payout. Reg. § 1.664-1(a)(7) states that a grantor, a noncharitable beneficiary, or a related or subordinate party (within the meaning of Section 672(c)) to either may act as sole trustee of a CRUT if that person determines the value of the nonmarketable trust assets by obtaining a "current qualified appraisal" from a "qualified appraiser" as defined under the Section 170 regulations. The final regulations added the grantor's spouse to the list of persons to whom an independent trustee cannot be related or subordinate. "Unmarketable assets" are defined as assets other than cash, cash equivalents or assets that can be readily sold for cash or cash equivalents. This includes real property, closely held stock and unregistered securities for which there is no available exemption permitting public sale. These rules are applicable for charitable remainder trusts created on or after December 10, 1998. A trust in existence as of December 10, 1998, whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to take advantage of this section for tax years beginning on or after December 10, 1998. Reg. § 1.664-1(f)(4).

B. Allocation of capital gains to income. A number of taxpayers have been setting up NIMCRUTs that define ordinary income to include realized capital gains. This allows the trustee to generate a large amount of trust income by selling appreciated assets. That income can be used to accelerate unitrust make-up distributions to the noncharitable beneficiary. The IRS has blessed this type of NIMCRUT in several private rulings, if several other requirements are satisfied. In one ruling, the Service suggested that pre-contribution capital gains could be allocated to income. In later rulings, the IRS carefully avoided extending its decisions to pre-contribution gains. In Reg. § 1.664-3(a)(1)(i)(b)(4), the IRS requires that proceeds attributable to pre-contribution gains must be allocated to trust principal in order for the trust to qualify as a charitable remainder unitrust. The regulation is effective for sales or exchanges of assets by NIMCRUTs after April 18, 1997; however, the IRS notes that the governing instrument, if permitted under local law, may allocate post-contribution capital gains to trust income. Also, the make-up amount does not have to be treated as a liability when valuing the assets of a NIMCRUT for purposes of determining how much has to be paid out.

C. Timing of annual annuity or unitrust payment. Under the prior regulations, the trustee of a charitable remainder trust had a reasonable time period after the close of a taxable year to make the annuity or unitrust distribution for the prior year. For CRATs and fixed percentage CRUTs, the annuity or unitrust amount may now be paid within a reasonable time after the close for the year for which it is due if:

1. the annuity or unitrust amount is income to the recipient; or

2. the trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the annuity or unitrust amount and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. Regs. §§ 1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g).

For CRATs and fixed percentage CRUTs that were created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due if the percentage used to calculate the annuity or unitrust amount is 15% or less. Regs. §§ 1.664-2(a)(1)(i)(b) and 1.664-3(a)(1)(i)(h). Reasonable time is defined as the date for filing the form 5227 (including extensions) which is usually April 15 of the following year. Regs. §§ 1.664-2(a)(1)(i)(c) and 1.664-3(a)(1)(i)(k). This provision was included to eliminate the perceived abuses of the short-term charitable remainder unitrusts that were highly touted several years ago.

D. Ordering rules for taxation of CRT distributions. Section 664(b) contains rules for determining the character of an annuity or unitrust distribution in the hands of the beneficiary. The distribution is treated first as ordinary income to the extent of the trust's current and undistributed ordinary income, then capital gain, then undistributed business taxable income then tax-exempt interest. The regulations add some examples to make clear that these ordering rules apply to all unitrusts, even when the payout is determined under the income exception method. Reg. § 1.664-1(d)(1)(iii).

E. NIMCRUTs with grantor and non-spousal family member as beneficiaries. Some taxpayers have been creating NIMCRUTs to try to pass assets to other family members. For example, a grantor creates a NIMCRUT that pays the lesser of trust income or 6% to the grantor for 15 years or until his death, if shorter. At the end of the 15-year term, the unitrust payments continue for to the grantor's daughter for life. The trustee invests in very low-yield assets for the first 15 years and builds up a significant make-up account. After the grantor's interest terminates, the trustee would shift to high-yield investments, and the unitrust make-up amounts all would pass to the grantor's daughter. The IRS believes that this type of shifting of benefits is contrary to the purposes of Section 2702. Section 2702 generally does not apply to charitable remainder trusts. Reg. § 25.2702-1(c)(3) will limit this exemption from Section 2702 to unitrusts that are for the donor, the donor's U.S. citizen spouse, or both. The exemption from Section 2702 also applies when there are only two consecutive non charitable beneficiaries and the grantor holds the second. Thus, in the example described at the beginning of this paragraph, the grantor's unitrust interest would be treated as a retained interest that is not a qualified unitrust interest under Section 2702. It would be treated as having a value of zero. As a result, the actuarial value of the grantor's retained unitrust interest would be treated as a Section 2702 gift to the daughter. The amendment is effective for transfers in trust made on or after May 19, 1997.

F. FLIP Unitrusts. Some donors create an income-only unitrust because the trust is funded with a nonmarketable asset that produces little or no income, and the donor does not want the trustee to worry about the payout requirement if it takes time to sell the asset. The donor would like to be able to switch to a straight unitrust once the asset is sold and the trust can readily produce the liquidity necessary to satisfy the payout. This previously was not possible. Effective December 10, 1998, the IRS will allow unitrusts that "flip" from income-only to straight unitrusts if the date or event triggering the conversion is outside the control of the trustee or any other persons. Reg. § 1.664-3(a)(1)(i)(c). Examples of permissible triggering events with respect to any individual include:

1. Marriage;
2. Divorce;
3. Death;
4. Birth of a child;
5. Sale of unmarketable assets.

Examples of impermissible triggering events include the sale of marketable assets and a request from the unitrust recipient or the unitrust recipient's financial adviser that the trust converts to the fixed percentage method. Reg. § 1.664-3(a)(1)(i)(d) and (e).

1. The final regulations also provide that the conversion to the fixed percentage method occurs at the beginning of the taxable year that immediately follows the taxable year in which the triggering date or event occurs. Any makeup amount is forfeited when the trust converts to the fixed percentage method. Reg. § 1.664-3(a)(1)(i)(c)(3). The IRS, despite the request of commentators, did not permit conversions from a CRAT to a CRUT or from a CRUT to a net income CRUT. Reformation of trusts is permitted in certain situations.

2. The final regulations are broader than the proposed regulations which permitted flip unitrusts only if:

   a. 90% or more of the trust assets contributed are nonmarketable;

   b. The trust mandates the switch to a straight unitrust payout either upon the sale of a specified asset, or the sale of enough assets to bring the nonmarketable portion of the trust corpus below 50%; and

   c. All remaining unitrust payments are made based solely as a fixed percentage of the trust assets, valued annually, with no make-up for any deficiencies in payout before the switch.

Also, the final regulations appear to permit any income-only unitrust, regardless of the nature of the current assets, to be converted to a FLIP unitrust if the reformation proceedings are commenced by June 8, 1999. Reg. § 1.664-3(a)(1)(i)(f)(3).

G. Sale of Valuable Artwork with a FLIP Unitrust. Florence has owned a significant piece of artwork for many years. It now has an estimated value of $3,000,000. Florence paid $100,000 for it. Florence intends to leave a significant portion of her estate to charity, including her artwork. She has become increasingly concerned, however, about maintaining a cash flow that will support her lifestyle. She also is considering selling her large estate home and moving into a penthouse apartment in the city. The piece is quite large and would not fit well in the city penthouse. For all these reasons, Florence is seriously considering selling the painting. But she does not like the idea of paying capital gains tax, which for this asset would be at the 28% rate applicable to collectibles.

1. A donor like Florence could create an income-only unitrust because the trust will be funded with a nonmarketable asset that produces no income, and she does not want the trustee to worry about the payout requirement if it takes time to sell the asset. However, she would prefer not to have an income-only CRUT permanently, even a NIMCRUT. She would like to be able to switch to a straight unitrust once the art is sold and the trust can readily produce the liquidity necessary to satisfy the payout.

2. This previously was not possible. However, since 1998, the IRS has allowed unitrusts that “flip” from income-only to straight unitrusts if the date or event triggering the conversion is outside the control of the trustee or any other persons. Treas. Reg. § 1.664-3(a)(1)(i)(c).

   a. Examples of permissible triggering events with respect to any individual include marriage; divorce; death; birth of a child; and the sale of unmarketable assets.

   b. Examples of impermissible triggering events include the sale of marketable assets and a request from the unitrust recipient or the unitrust recipient’s financial adviser that the trust converts to the fixed percentage method. Treas. Reg. § 1.664-3(a)(1)(i)(d) and (e).

3. The regulations also provide that the conversion to the fixed percentage method occurs at the beginning of the taxable year that immediately follows the taxable year in which the triggering date or event occurs. Any makeup amount is forfeited when the trust converts to the fixed percentage method. Treas. Reg. § 1.664-3(a)(1)(i)(c)(3).

4. Assume Florence creates a FLIP unitrust and funds it with her $3,000,000 artwork. Fifteen months later, the trustee sells the piece for $3,000,000, and reinvests the proceeds in marketable securities. The CRUT converts to a straight unitrust that pays Florence 5% per year, or $150,000 in the first year following the conversion. Without the CRUT, the tax on the sale, federal and state, would have been $900,000. If Florence had invested the remaining $2,100,000 and paid herself 5%, she would receive only $105,000 per year. The CRUT also provides Florence with an income tax deduction, although a small one because the deduction is calculated off the painting's basis.

XI. Early Termination of Charitable Remainder Unitrusts

A. During booming stock markets such as those in the 1990’s and up until 2008, many people took advantage of the opportunity afforded by charitable remainder trusts (“CRT”) to make tax-deductible contributions to charity while at the same time reserving substantial future income on the donated property. The expectations of these CRT donors were not realized as the stock markets subsequently fell dramatically. The disappointment was particularly sharp for those who established charitable remainder unitrusts (a “CRUT”), or a variation on a CRUT in which distributions each year are limited to the income realized by the CRUT during that year. Although capital gains deriving from post-contribution appreciation of assets may be included in that "income," recent experience shows that in years when the stock market is down that may not provide much help. Careful harvesting of gains, while avoiding sales that realize losses, may also be of some assistance, but such techniques will not necessarily create sufficient income to fund fully the payments that the donor otherwise would receive.

B. Even for CRUTs that are not limited in their distributions to income, the precipitous decline in the stock market has, for many donors, meant that the actual cash flow (both from the CRUT and from other assets) may be substantially less than had been anticipated. As a result, an increasing number of donors have considered terminating their CRTs by paying the current value of the remainder interest to the charitable beneficiary and returning the remaining assets to the donor. Since CRTs are often designed to leave charity the minimum 10% charitable remainder value, terminations of these trusts can result in the bulk of the assets being returned to the donor.

C. Federal Tax Law Aspects of Early Termination

1. Self-Dealing

a. CRTs are subject to certain of the rules in the Internal Revenue Code governing private foundations, including the self-dealing rules that prohibit most transactions between the foundation and a disqualified person. Under these rules, a donor to a CRT is a disqualified person. However, since the private foundation rules are not applicable with respect to amounts payable by a CRT to a non-charitable beneficiary, the periodic unitrust payments to the income beneficiary do not violate the self-dealing rules. The IRS has recently ruled that the terminating payment to an income beneficiary upon the early termination of the CRT is also protected under this exception, provided certain conditions are met.

b. In Private Letter Ruling 200208039 (November 29, 2001), the IRS considered the proposed early termination of a CRUT that paid the donor the lesser of the 8% unitrust amount and the net income of the trust for the year in question. The ruling does not reveal whether the CRUT in question contained a “make up” provision, as permitted by IRC Section 664(d)(3)(b), that would allow for payments to the donor of excess income in future years to make up for shortfalls in prior years. The facts recited included that the payout to the income beneficiary had averaged less than 3% in recent years. The ruling notes that the trust would be terminated in accordance with applicable state law and that the income beneficiary did not have a medical condition that could lead to a shorter life expectancy than that assumed in the IRS actuarial tables. Based on those representations, the private letter ruling approved a termination of the CRUT whereby the income beneficiary received the actuarial value of an 8% unitrust interest and the charity received the residue.

c. The letter ruling states that whether the self-dealing rules apply depends on whether the allocation of trust assets to the income beneficiary may properly be considered as "payable under the terms of such trust" and "directed by the terms of the governing instrument of the trust and not discretionary with the trustee" under Section 53.4947-1(e) of the regulations. According to the IRS, this question reduces to "… whether early termination may be expected to result in a greater allocation of the trust assets to the income beneficiary, to the detriment of the charitable beneficiary, than a non-early termination."

d. The letter ruling accepted the method proposed by the taxpayer for determining the amounts payable upon the early termination: determine the present values of the income and remainder interests effective on the date of termination, using the discount rate in effect under Section 7520 on the date of termination, and using the methodology under Section 1.664-4 of the regulations for valuing interests in CRTs. It is noteworthy that, even though the trust was a CRUT that paid the lesser of the income and the unitrust amount, the IRS permitted the donor to value the unitrust interest based on the full 8% payout called for in the trust instrument.

2. Income Tax Consequences

a. In Private Letter Ruling 200127023 (April 4, 2001), the IRS also addressed income tax consequences of an early termination of a CRT. The Service ruled that the property received by the income beneficiary upon termination is not an annuity or unitrust payment and is therefore not governed by the "tier system" of Code Section 664(b). Under the tier system, the annuity or unitrust payments to the income beneficiary are characterized in the hands of the recipient first as ordinary income, second as capital gain, third as other income, and fourth as trust corpus.

b. However, in the case of an early termination, the letter ruling concludes that since the income beneficiary is disposing of his or her interest in the trust in exchange for money or property, the transaction is governed by Code Section 1001, which provides that the gain from the disposition of property is the excess of the amount realized over the adjusted basis of the property. Where, as here, the property disposed of is a term interest, such as an income interest in a trust, the portion of the adjusted basis determined under Section 1015, which contains rules for determining the basis of a transfer in trust, shall be disregarded unless the entire interest in property is transferred to a person or persons.

c. The letter ruling takes the position that the entire interest in property would not be transferred to a third party upon the termination of the trust. Thus the income beneficiary's basis in his or her interest in the trust is disregarded, and the income beneficiary must realize the full amount received as gain. The sale of an income interest in a trust is treated as the sale of a capital asset whose holding period commences on the date the beneficiary first held the interest. Thus, the income beneficiary must recognize the entire amount received upon termination of the trust as either long-term or short term capital gain, depending on the amount of time that has elapsed since the property was contributed to the trust.

d. In Private Letter Ruling 200127023, the IRS expressly based its conclusions on the fact that any distribution of assets in kind would be made in a pro rata manner. The Service did not explain why this should be necessary, but it may derive from a concern that the assets would not be divided fairly if any of them were nonmarketable and, therefore, difficult to value. It is difficult to see that there should be any income tax concerns resulting from a non pro rata distribution, however. Even if the IRS were to treat each party as having received a pro rata share of each asset followed by a deemed sale between the parties to reach the non pro rata holdings, the income beneficiary would have a basis equal to the then fair market value of the assets. Thus no additional tax would be owed.

D. State Law Procedural Matters

1. Consensual Termination Without Court Proceedings

a. When the settlor of a trust does not reserve the power to amend or revoke the trust, the trust cannot ordinarily be terminated prior to the time designated for termination, if any, in the trust instrument. In certain circumstances, however, an irrevocable trust may be modified or terminated. The Restatement (Third) of Trusts (the "Restatement") sets forth several limited circumstances in which an irrevocable trust may be prematurely terminated. Among these are (i) where it become impossible or illegal to accomplish the purposes of the trust, and the terms of the trust make no provision for the situation; and (ii) where changed circumstances are such that the purposes of the trust can no longer be accomplished.

b. Even where the purposes of the trust have not been frustrated, it may still be possible to terminate the trust by agreement of the appropriate parties. For example, where all beneficiaries of the trust agree to terminate the trust, and the purposes of the trust have been essentially accomplished, the trust may be terminated. Or, where the settlor and all the beneficiaries agree to terminate the trust, regardless of whether the purposes of the trust have been accomplished, the trust may be terminated. Specifically, Restatement § 65(2) states:

> If termination or modification of the trust under Subsection (1) [termination or modification by consent of all the beneficiaries] would be inconsistent with a material purpose of the trust, the beneficiaries cannot compel its modification or termination except with the consent of the settler . . .

c. It is clear that, as stated in the commentary to the corresponding rule in Restatement (Second) of Trusts ("Restatement (Second)"), this rule "is applicable where the settlor and the beneficiaries consent to a reconveyance of the trust property to the settlor and also where they consent to the conveyance of the trust property to the beneficiaries or to a third person. It is applicable whether or not the settlor is one of the beneficiaries." Furthermore, it is applicable "although the settlor does not reserve a power of revocation, and even though it is provided in specific words by the terms of the trust that the trust shall be irrevocable." Id. Of particular importance, the commentary under Restatement (Second) states that:

> If by the terms of the trust it is provided that the trust shall not terminate until a certain time, or until the happening of a certain event, and the sole beneficiary, or if there are several beneficiaries, all of the beneficiaries, none of them being under an incapacity, desire to terminate the trust, and the settlor consents to its termination, the trust will be terminated, although the specified time has not arrived or the specified event has not happened, and the beneficiary without the consent of the settlor could not compel the termination of the trust.

d. Section 65 of the Restatement thus states rules whereby an irrevocable trust can be modified or terminated by agreement of the appropriate parties. The authors believe that these rules are recognized in most, if not all, states, but, of course, the law of the relevant jurisdiction should always be confirmed before proceeding with the termination of any CRT.

e. It will be clear in most jurisdictions that the settlor and all of the beneficiaries (as long as the beneficiaries are all competent and there are no contingent beneficiaries) may modify or terminate an irrevocable trust, even though the purposes of the trust have not been accomplished. Since this is a common law rule, however, it is stated in judicial decisions, which necessarily arise from court proceedings. This circumstance might raise a question whether court action is necessary to effect such a termination.

f. Not only does common sense suggests that a judicial proceeding will not ordinarily be necessary, the Restatement, in an advancement over Restatement (Second), explicitly recognizes that the modification or termination of a trust can be achieved by agreement of the appropriate parties without the authorization of a court. Thus, a private agreement between the settler and all the beneficiaries will be sufficient to terminate a trust, even though all the material purposes of the trust have not been accomplished.

2. Attorney General Involvement

a. In the two recent private letter rulings in which the IRS has approved early termination of a CRT, it made a point of the fact that the state attorney general consented to the termination. In particular, Private Letter Ruling 200127023, specifically based its favorable ruling on the "assumption" that the state attorney general was a party to the proceeding that resulted in the termination.

b. One of the roles of the attorney general in most, if not all, state jurisdictions is to protect charitable trusts within the state. In view of the concern expressed by the IRS that "gamesmanship" could be exercised with respect to CRTs where the income beneficiary has a shortened life expectancy due to health conditions, it is understandable that the IRS would take comfort from the participation of the state attorney general.

c. However, in the other area where gamesmanship could be played, involving income-only CRTs where the expected income is far below the amount that otherwise would be payable under the trust, the IRS has expressed no concern. Indeed, it specifically approved termination using the actuarial tables in Private Letter Ruling 200208039, where an 8% unitrust was able to pay out only 3% because of that lower level of income on the CRT's investments. Arguably, the IRS could have required that the value of the charitable remainder interest be computed using an assumed 3% payout rate rather than 8%.

d. While it is possible that the IRS did not take that position because of the participation of the state attorney general and the consent of the charitable organization, the absence of any discussion of that point suggests that it is more likely that the IRS simply had made the determination, at least with respect to that private letter ruling, that application of the actuarial tables in the same way as they apply for purposes of determining the charitable deduction when a donation is made to an income-only CRT is also appropriate when the trust is being terminated. Certainly, there is an element of fairness in that approach that gives it merit.

e. The participation of the state attorney general might also be important in situations where the CRT owns difficult to value assets or the income beneficiary has a controlling relationship with the charitable organization suggesting that the charitable organization does not act independently. However, in the absence of those factors, and assuming that the trust assets are valued fairly and the actuarial tables are applied with scrupulous fairness, it does not appear that failure to get prior consent from the state attorney general should change the logic which resulted in a ruling in favor of the transaction in the private letter rulings discussed in this article. Moreover, although the law of the applicable jurisdiction would have to be carefully reviewed, a private agreement to terminate a CRT under these circumstances should not require the prior approval of the state attorney general under state law.

E. Variations

1. As discussed above, the IRS takes the position is that the income beneficiary will owe capital gains tax on the full value of the interest payable to him or her upon termination of the trust. It may be possible to defer (or possibly avoid) this tax by having the assets otherwise distributable to the income beneficiary instead be distributed to another CRT. If the second CRT has a higher payout rate than the original CRT, or has the same rate but no income-only limitation, this may be sufficient to permit the CRT to meet the beneficiary's cash flow needs.

2. It appears that this could be accomplished through a two-step process. First, the income beneficiary would assign all of his or her right to future payments from the CRT to the new CRT. (The original CRT would have to permit assignments of interests for this to be possible – it cannot be a spendthrift trust). The new CRT would then negotiate an early termination of the old CRT with the charitable remainder beneficiary. The lump sum payment from the first CRT would then be paid into the second CRT. This transfer would not be subject to capital gains tax. Although this admittedly requires that a portion of the assets be permanently transferred to charity (so that a smaller amount of money is "working for" the income beneficiary in the new CRT), this might nevertheless be entirely consistent with the income beneficiary's charitable objectives

while at the same time providing a more predictable or higher payout from the new CRT.

3. It might also be possible to do a partial termination of a CRT. With respect to a CRUT, no additional changes in the trust instrument should be required since the payout is based on a percentage of the value of the trust assets (although there may need to be an adjustment made for any payments due during the year of termination if the termination does not occur at the beginning of the taxable year). If a charitable remainder annuity trust were to be partially terminated, some further amendment of the trust instrument would be necessary since the original annuity would be a fixed dollar amount, which should presumably be reduced proportionately by the percentage of the trust terminated. Since the Restatement sections cited earlier allow for modification of a trust as well as termination, it would seem that a charitable remainder annuity trust could be modified to permit this.

4. One of the things that makes a CRT popular for some donors is that it provides a budgeting mechanism. It is viewed as a way of putting principal out of reach, while providing a steady flow of income to a beneficiary. For those find CRTs attractive for this reason, the opportunity of accomplishing an early termination may not be a welcome one. On the other hand, those who are disappointed by the results of their CRTs, either because market performance is below their expectations or because of a change in circumstances, may find this to be an important planning opportunity. In any event, the recent private letter rulings are a welcome development, and the possibility of terminating a CRT early if all parties agree might even encourage more individuals to create them in the first place.

XII. Charitable Lead Trusts

A. A charitable lead trust is the flip-side of a charitable remainder trust.

1. In this case, the charitable beneficiaries receive a stated amount each year for a specified term of years or for the life or lives of an individual or individuals, and at the end of the period the remaining corpus is distributed to or in trust for the grantor's descendants or other noncharitable beneficiaries.

2. A charitable lead trust enables a person to satisfy current charitable intentions and at the same time transfer significant amounts of property to his beneficiaries at a reduced transfer tax cost.

B. As with charitable remainder trusts, lead trusts may be one of two types--either an annuity trust, in which the charitable beneficiary receives a sum certain, or a unitrust, in which the charity receives a fixed percentage of the value of the trust property.

1. The lead trust is very flexible; it may allow the trustee discretion in determining which charities will receive payments, or it can provide for specific charities. Unlike a charitable remainder trust, there is no minimum payout for a charitable lead trust, and it can be for any term of years. The trust may be created irrevocably during life or at death. The reasons for and benefits from lifetime and testamentary lead trusts are slightly different.

2. In. Revenue Procedures 2007-45, 2007-29 I.R.B. 89, and 2007-46, 2007-29. I.R.B. 102 (June 22, 2007), the IRS released sample charitable lead annuity trusts provisions. These revenue procedures provide sample forms, annotations, and alternate provisions for inter vivos and testamentary charitable lead annuity trusts. The suggested language is similar in many respects to that previously provided by the IRS for charitable remainder trusts and to the form language already used by most practitioners. Sample forms are provided for both grantor and nongrantor charitable lead annuity trusts and for a lead period measured by one or more lives as well as a term of years. The forms do not deal with charitable lead unitrusts.

C. Lifetime Trusts

1. An individual can use a lifetime charitable lead trust to make charitable contributions in a way that is preferable to making the gifts personally. It is ideally suited for a person who makes significant annual charitable donations and who has difficulty staying within the annual percentage limitations for contributions.

2. Upon creating the trust, the grantor makes a gift to charity of the present value of the charity's right to receive trust payments. This gift qualifies for the federal gift tax charitable deduction.

3. Generally, when the grantor creates the trust, he will not receive an income tax charitable deduction.

   a. One exception is where the charitable lead trust is a "grantor" trust, in which the trust income is taxable to the grantor under the applicable income tax rules. In this case, the grantor is entitled to claim an income tax charitable deduction in the taxable year in which the trust is created for the present value of the annuity interest.

   b. The deduction will, however, be subject to a limitation of 30 percent of the grantor's contribution base (20 percent if long-term capital gain property is used to fund the trust) because contributions to a charitable lead trust are treated as "for the use of" the charitable donees (Treas. Reg. § 1.170A-8(a)(2)). In addition, the income of the trust in the years after its creation will be taxable to the grantor, with no further charitable deduction allowed, even though the trust actually distributes the income to charity. Such trusts often invest in municipal bonds so that the grantor can avoid paying tax on the trust income.

4. If the charitable lead trust is not a grantor trust, the grantor will not receive any income tax charitable deduction for the amounts paid to charity, either when the trust is created or subsequently. However, the income generated by the trust's assets will be removed from the grantor's gross income. Thus, the income tax effect on the grantor will be equivalent to his receiving an income tax charitable deduction each year, but without the applicable percentage limitations for contributions.

5. Unlike a charitable remainder trust, a charitable lead trust is not exempt from taxation, and the trustee must file a fiduciary income tax return (Form 1041) each year. However, the trust's taxable income should be low or nil in most cases, since the trust will receive a charitable deduction for the payments made to charity (IRC § 642(c)(1)). Any income the trust earns in excess of the yearly annuity amount will be taxed to the trust at its separate rates. If this excess income is ultimately paid to the remainder beneficiary, it may be subject to the throwback rules.

6. The trust will be entitled to a charitable deduction only for amounts paid for charitable purposes from gross income (IRC § 642(c)(1)). To maximize the trust's income tax charitable deduction, therefore, the charitable payments should be made as much as possible from trust income, before trust principal is used. In addition, the trust should provide that the amounts be paid in the following order:

    a. from ordinary income (including short-term capital gain) which is not "unrelated business income" (see IRC § 681(a); unrelated business income includes income from a business directly carried on by the trust or a partnership of which the trust is a partner; if such income is used to satisfy the annuity or unitrust obligation, the unlimited charitable deduction usually allowed to the trust under IRC § 642(c) will be subject to certain percentage limitations);

    b. from long-term capital gains;

    c. from unrelated business income;

    d. from tax-exempt income; and

    e. from principal.

7. Unless the trust instrument makes such specific provision, local law may apply to determine the order in which the charitable obligation is satisfied. To the extent that local law does not provide for ordinary income to be used first to satisfy the annuity or unitrust payment, the trust's charitable deduction may be reduced or denied. If local law is inapplicable, the IRS will allocate the annuity or unitrust payment proportionately among each class of income realized by the trust, an allocation that may also serve to reduce the amount of the deduction allowed.

   a. In two private letter rulings, the IRS has stated that it will ignore the provisions of a charitable lead trust instrument that directs the payment of amounts from certain classes of income and instead will treat the income as consisting of a proportionate share of each type of income earned by the trust (see Ltr. Rul. 8940055 (July 11, 1989), 8727072 (April 8, 1987)).

   b. These rulings recognize that Treas. Reg. § 1.642(c)-3(b)(2) states that the instrument may specify the sources of payments, but the rulings hold that a specific allocation provision does not apply unless it has substantive economic effect, which is not the case in a lead trust that requires the same amount (or amount determined by the same percentage formula) to be distributed each year. There is no binding authority on this issue.

8. A lifetime charitable lead trust also can produce significant federal transfer tax benefits for the grantor. When the grantor creates the trust, he makes a gift of both the annuity (or unitrust) interest and the remainder interest. However the present value of the interest given to charity generates no federal gift tax, because of the gift tax charitable deduction (IRC § 2522). The value of the charitable interest is determined by using the same tables used for charitable remainder trusts. If the charitable lead trust is an annuity trust, Table B of the Treasury tables is used. For a charitable lead unitrust, the special unitrust tables (see Treas. Reg. § 1.664-4) are used to determine the value of the remainder interest and this value is then subtracted from the fair market value of the trust property to obtain the value of the charitable interest.

   a. The gift of the remainder interest is a taxable gift and does not qualify for the annual exclusion, since it is a "future interest." However, because part of the value of any transfer to a charitable lead trust is offset by the charitable deduction, the lead trust enables the grantor to transfer assets to his descendants at a greatly reduced transfer tax value.

   EXAMPLE: An individual buys a $100,000 bond that yields 7 percent and uses the income to make annual gifts to his college alma mater. At the end of 15 years, he decides to give the bond to his daughter. The individual has made a taxable gift of $100,000 to his daughter. The individual could have funded a 15-year charitable lead trust with the bond instead. The trust would provide that $7,000 would be paid annually to the college, and at the end of the 15-year term, the property would pass to the daughter. If the applicable interest rate for the transfer is 6 percent, the value of the college's right to receive $7,000 per year for 15 years is about $68,000 under Table B. The individual would then have made a taxable gift only of the remainder, the value of which is $32,000. Thus, his daughter would still have received $100,000 at the end of 15 years, but at a gift tax cost of about 32 percent of an outright gift.

b. In some cases, a charitable lead annuity trust can be structured so that after the charitable term, the trust assets can pass to the remainder beneficiary free of gift tax. To work, the annuity payout must exceed the applicable interest rate assumption on which the Treasury tables are based, and be made for a sufficient number of years. Because the tables assume that the trust assets can only earn a fixed amount annually, from a mathematical viewpoint a payout sufficiently in excess of that fixed amount would require the trust to exhaust its entire corpus (in addition to the assumed yearly income on the unconsumed balance) to satisfy the annuity obligation. This would leave no remainder to be transferred, and so for gift tax purposes the value of the remainder interest would be zero. If an asset could be found that actually produced a current return equal to the annuity payout, the full value of the contributed property would in fact pass to the remaindermen tax free.

EXAMPLE: If an individual transfers $100,000 to a charitable lead annuity trust to pay one or more charities a $7,800 annuity each year for fifteen years, and the applicable interest rate at the time is 2 percent, the annuity interest will be valued at $100,000 for gift tax purposes, and the trust remainder will be zero. However, assuming the trust will in fact earn at least 7.8 percent, the entire $100,000 will pass to the remainder beneficiary at the end of the annuity term free of gift tax. The remainderman will also receive any underlying appreciation in the trust property, plus any income earned in excess of 7.8 percent. To the extent that investment performance is less than 7.8 percent, trust principal must be used to pay the annuity amount, and the remainderman will ultimately receive less property. Since the grantor is not treated as making an adjusted taxable gift when the trust is created, the entire $100,000 will be excluded when the grantor's estate tax is computed.

c. The following table illustrates the "zero-out" annuity rate for various charitable annuity terms and different interest rates:

Number of Years	1% Zero-Out Annuity Rate	2% Zero-Out Annuity Rate	3% Table Zero-Out Annuity Rate	4% Table Zero-Out Annuity Rate	5% Table Zero-Out Annuity Rate	6% Table Zero-Out Annuity Rate	7% Table Zero-Out Annuity Rate	8% Table Zero-Out Annuity Rate	9% Table Zero-Out Annuity Rate
8	13.1	13.7	14.3	14.9	15.5	16.1	16.8	17.4	18.1
9	11.7	12.3	12.9	13.4	14.1	14.7	15.4	16.0	16.7
10	10.6	11.2	11.7	12.3	12.9	13.6	14.2	14.9	15.6
15	7.3	7.8	8.4	9.0	9.6	10.3	11.0	11.7	12.4
20	5.6	6.2	6.7	7.4	8.0	8.7	9.4	10.2	11.0
25	4.6	5.2	5.7	6.4	7.1	7.8	8.6	9.4	10.2

d. Because the interest rate assumption underlying the annuity tables fluctuates monthly, it will be very difficult to create a "zero-out" charitable lead annuity trust. Such a trust is possible only where investment results diverge significantly from the table rates. The monthly table rates, however, are keyed to market interest rates for debt instruments, so it is unlikely that fixed income assets producing a sufficiently higher current return will be available. However, venturesome taxpayers might be willing to assume that investments such as common stocks or real estate would produce a combination of current yield and appreciation sufficient to produce the zero-out result. Of course, the down-side risk with these investments is that less than expected performance could result in the entire trust actually being consumed by the charitable annuity.

e. One way of reducing the down-side risk and of creating a high return asset for a charitable lead annuity trust is to create a family limited partnership and then fund the charitable lead annuity trust with discounted family limited partnership interests. The IRS often takes a hard line approach against claims of a valuation discount. However, the use of discounts in valuing closely held assets, such as family limited partnerships, is consistently recognized by the courts and supported by professional appraisers. Taxpayers have successfully obtained discounts aggregating 10% to 50% or more. The family limited partnership, as is shown in the following example, can be used quite successfully with a zero-out charitable lead annuity trust.

EXAMPLE: Donor wants to transfer $1,000,000 to a charitable lead annuity trust for fifteen years at a time when the monthly interest rate assumption underlying the IRS valuation tables is 3%. The remaindermen are the donor's children. In order to "zero-out" his or her gift, the trust may pay the charity $84,000 each year. If the trust assets actually return 8.4% or more on average over fifteen years, at least $1,000,000 will pass to donor's children for a $0 gift tax cost. Moreover, the charity will have received $1,260,000 from the annual annuity payments. Unfortunately, the assets that donor was planning to use only produce a return of 6.8%, which is not sufficient to "zero-out" the trust. Donor's solution is to create a family limited partnership and fund it with various assets, such as real estate and securities. Then he transfers limited partnership interests with a net asset value of $1,235,000 to the charitable lead annuity trust. Thus, the charitable lead annuity trust will achieve a return of $84,000 each year (6.8% of $1,235,000). To take into account the lack of control and lack of marketability of the limited partnership interests, donor values those interests at a 19% discount, or at $1,000,000, for purposes of the transfer. The effective yield on the discounted value of the limited partnership interest is 8.4% ($84,000 ÷ 1,000,000). The charity can receive an annuity of $84,000 and donor has reduced his eventual gift of the remainder to his children to zero.

f. One cannot reduce the gift tax value of the remainder interest to zero using a charitable lead unitrust. Because the unitrust payment is equal to a fixed percentage of the value of the trust assets determined annually, the income distributions will never be treated as fully exhausting the trust principal. For example, if, in the clause b example, the individual transferred $100,000 to a 15-year charitable lead unitrust which pays a charity 8.4 percent of its value each year, and the applicable interest rate is 3 percent at the time of the transfer, the donor will have made a taxable gift of $27,500.

D. Testamentary Trusts

1. In addition to an inter vivos transfer, one can create a charitable lead trust under a will, to take effect at death. A testamentary charitable lead trust can be used to reduce federal estate tax that otherwise will occur at the testator's death. The testator's estate may claim a federal estate tax deduction for the value of the charitable interest, and, as is true of the inter vivos transfer, only the remainder will be subject to transfer tax.

2. The testamentary charitable lead trust provides no income tax benefit to the testator or the noncharitable beneficiaries. While it can be used to reduce the estate tax cost of transferring assets to those beneficiaries at death, this fact does not necessarily leave those beneficiaries better off than if the trust assets passed directly to them at the decedent's death with no charitable deduction. This is because use of a charitable lead trust postpones the time at which the noncharitable beneficiaries come into

possession of the trust assets. The lost use of the trust assets by those beneficiaries during the charitable term is a significant detriment, which in most cases will outweigh the estate tax savings from using the trust. The trust does provide benefits to charity that would not otherwise be available, however. Therefore, an individual with clear charitable inclinations may wish to use such a trust even though it may result in a cost to his family. On the other hand, individuals with no clear charitable motives should generally avoid creating such a trust.

E. Annuity Trust vs. Unitrust

1. The earlier discussion of charitable remainder trusts concluded that, at low payout rates, annuity trusts resulted in remainder interests of a higher value than comparable unitrusts because increases in the income of the annuity trust accrue entirely to the benefit of the remainder beneficiaries. Therefore, a larger charitable deduction could be obtained with an annuity trust in many cases. At high payout rates, however, the unitrust resulted in the larger deduction because the high payout in a unitrust does not consume trust principal as quickly as it does in an annuity trust.

2. The same reasoning applies to charitable lead trusts; however, since the term interest is the charitable interest in a lead trust, a charitable lead unitrust will maximize the charitable deduction at lower payout rates (because it produces a smaller remainder interest).

   EXAMPLE: An individual creates a $100,000 charitable lead unitrust that provides for annual payments to charity equal to 5 percent of the fair market value of the trust property for 15 years, remainder to his children. The applicable interest rate at the time is 8 percent. The value of the charitable interest is about $50,886. The value of the remainder is about $49,114 under the Treasury Department unitrust tables and is a taxable gift. If the individual had created a charitable lead annuity trust that paid charity $5,000 for 15 years, the value of the annuity would be only $42,798 and the individual would have made a taxable gift of a remainder interest worth $57,202.

F. Generation-Skipping Tax Issues

1. As previously explained, because the taxable gift in a charitable lead trust is a gift of a future interest, the trust permits a grantor to transfer assets to descendants at a reduced transfer tax value for gift tax purposes. This same reduced value can be used to lower the GST tax cost where the remainder beneficiary of the lead trust is a grandchild or multi-generation trust, although the ability to obtain GST tax savings has been limited.

2. If a grandchild or a multi-generation trust is a remainder beneficiary of a charitable lead trust, GST tax will be incurred after the termination of the

charitable interest unless the grantor allocates GST exemption to the trust. The amount of GST exemption required to exempt the trust completely is that amount which will produce an "applicable fraction" of 1.

3. In the case of a charitable lead annuity trust created after October 13, 1987, IRC § 2642(e) provides that the applicable fraction is a fraction whose numerator is the "adjusted GST exemption," and whose denominator is the value of the trust property at the end of the charitable annuity term.

   a. The "adjusted GST exemption" is defined as an amount equal to the GST exemption allocated to the trust, compounded annually over the charitable term at the interest rate used to determine the value of the charitable interest under the Treasury Department's valuation tables.

   b. In order to exempt a charitable lead annuity trust from GST tax, the grantor must determine how much GST exemption, when compounded at the valuation table interest rate, will equal the expected value of the trust when the charitable term expires.

   EXAMPLE: An individual creates a $1 million charitable lead annuity trust to pay an annual annuity of $70,000 to charity for 10 years, and to pay the trust principal remaining at the end of that period to his grandchildren. Assume that the interest rate used to value the transfer is 8 percent. Using the factor from Table B of the valuation tables, the gift tax value of the charitable gift is $469,707, and the gift tax value of the remainder is $530,293. If the individual allocates $530,293 of GST exemption to the trust, the adjusted GST exemption would be $1,144,863 ($530,293 compounded at 8 percent annually for 10 years). If the value of the trust principal at the end of the charitable term does not exceed the adjusted GST exemption, the trust will be entirely sheltered from GST tax and there will be no tax when the property passes to the grandchildren. However, if the trust principal has appreciated to a greater amount, the applicable fraction of the trust when the charitable term ends will be less than 1 (and the inclusion ratio of the trust will be greater than zero). If the individual is still living at that time and has sufficient additional GST exemption left, he could make an additional allocation of GST exemption to the trust and avoid the shortfall. Otherwise, GST tax will be incurred when the charitable term expires.

4. The adjusted GST exemption has no relation to the amount of the charitable annuity. Thus, if the trust in the previous example paid only $50,000 per year to charity, and if $530,293 of GST exemption were

allocated to the trust, the adjusted GST exemption would still be $1,144,863.

a. If the trust principal is worth less than the adjusted GST exemption when the charitable term expires, then the transferor will have allocated too much GST exemption to the trust.

b. In the foregoing example, if the trust principal is still worth $1 million upon expiration of the charitable term, only $463,193 of GST exemption would have been required to shelter the trust completely. There is no way to recover any excess exemption allocated to the trust in such a case.

c. Determining the amount of GST exemption to allocate to a charitable lead annuity trust in many cases may become a guessing game. However, if the value of the trust principal at the end of the charitable term can be reasonably ascertained at the time the trust is established, it should be possible to make the correct allocation of GST exemption to the trust at the outset, and use the exemption to exempt the entire transfer from GST tax.

EXAMPLE: An individual purchases a ten-year Treasury Bond with a face value at maturity of $1 million and an annual coupon rate of 7 percent, and transfers the bond to a new, ten-year charitable lead annuity trust. The interests transferred are valued using an 8 percent interest rate. The trust will pay an annual annuity of $70,000 to charity, and will pass to the individual's grandchild at the end of the annuity term. If the individual allocated $463,193 of GST exemption to the trust (representing the present value of $1 million in ten years discounted at 8 percent), the adjusted GST exemption will be $1 million and, at the end of the charitable term, the trust should be completely sheltered from GST tax.

5. Charitable lead unitrusts are not affected by IRC § 2642(e). For these trusts, the numerator of the applicable fraction is the amount of GST exemption allocated to the trust, with no adjustments, while the denominator equals the value of the property transferred to the trust, reduced by the amount of the charitable deduction allowed with respect to the transferred property, based on the present value of the charitable interest at the time of the transfer (IRC § 2642(a)). This results in less GST exemption being required to shelter the trust than if no charitable interest were involved. Congress did not give any reason why it decided to treat unitrusts different from annuity trusts. Because of the distinction, the grantor of a charitable lead unitrust can use the GST exemption more effectively and more precisely than is possible with an annuity trust to transfer assets to remote descendants.

EXAMPLE: An individual creates a $1 million charitable lead unitrust to pay an annual amount equal to 7 percent of the trust assets to charity for 10 years, and to pay the remaining trust principal at the end of the term to his grandchildren. If the interest rate used to value the transfer is 8 percent, the gift tax value of the charitable gift is $488,295, and the gift tax value of the remainder is $511,705. If the individual allocates $511,705 of GST exemption to the trust ($1 million less $488,295 charitable gift), the entire transfer to the grandchildren at the end of the term will be exempt from GST tax.

G. Sale of Remainder Interest In A Charitable Lead Annuity Trust

1. There is an alternative way to leverage use of the GST exemption with a CLAT, if the CLAT is created in conjunction with a separate generation-skipping trust.

   EXAMPLE: In 2018, Client funds a 15-year CLAT with $2,000,000 of property and pays an annuity of $200,000 per year to specified charities. The CLAT provides that at the end of the term, the CLAT property will be distributed in equal shares to Client's three children, and any deceased child's share is payable to the child's estate. Client's husband predeceased Client and a $1,000,000 GST trust was created at his death. Shortly after the CLAT is created, the trustees of the GST trust purchase the remainder interest in the CLAT from the children for $275,000. At the end of 15 years, the GST trust receives $2,000,000 or more of assets, which should be fully GST exempt because they were acquired for full and adequate consideration.

2. The remainder interest in a CLAT is valued for purposes of the sale in the same manner as it is valued for purposes of determining the initial gift when the trust is created. The value of the remainder interest equals the value of the property less the value of the retained annuity, which is a qualified interest under Section 2702.

3. The sale of a remainder interest in a CLAT may have income tax consequence to the selling remaindermen. The CLAT will have a uniform basis in the transferred property equal to the basis in the hands of the grantor (adjusted for gift tax paid, if any). The remaindermen are treated as having a proportionate share of that basis for the purpose of determining gain if the remainder interest is sold.

   EXAMPLE: The $2,000,000 of assets transferred to the CLAT have an aggregate basis of $1,000,000. The remainder interest represents about 14% of the value in the trust ($275,000/$2,000,000) so the remaindermen have about 14% of the basis, or $140,000. If the children sell the remainder interest in the CLAT to a GST trust, they would recognize gain of about $135,000 ($275,000-$140,000).

If the CLAT is funded with cash, and the remainder interest is sold shortly after the trust is funded, the remaindermen should recognize little or no gain

4. The GST trust that acquired the remainder interest takes a basis in it equal to what it paid. For instance, the GST trust in the example above will have a basis in the remainder interest of $275,000. When the CLAT terminates, the GST trust probably should take a basis in the assets it receives equal to its basis in the remainder interest. It thereafter would recognize gain (or loss) as assets are sold. If the distribution upon termination of the CLAT is in the form of cash, the IRS would probably conclude that the GST trust would recognize gain immediately to the extent the cash exceeded its basis.

H. Planning Considerations

1. The grantor of a lifetime charitable lead trust should avoid retaining the right to designate the charitable beneficiaries of the trust. If the grantor dies during the charitable lead term, the trust property will be included in his estate and all transfer tax benefits of the trust will be lost.

2. The grantor may give the trustee, or an advisory committee designated in the trust instrument, the power to select charitable beneficiaries for the annual charitable distributions, or to select among certain designated beneficiaries. If this is done, the power should be limited to organizations described in Code Section 170(c), since only Section 170(c) organizations are permitted charitable beneficiaries of a lead trust.

3. Like a charitable remainder trust, a charitable lead trust is exempt from the excess business holding restrictions of Code Section 4943 and the jeopardizing investment rules of Code Section 4944, provided that the charitable portion of the lead trust does not exceed 60 percent of its fair market value. Therefore, a properly structured lead trust can be funded with closely-held business assets, as a method for eventually passing those assets to descendants at a reduced transfer tax cost.

4. As previously explained, the Treasury tables in effect since May 1988 will make it difficult, if not impossible to create a “zero-out” charitable lead annuity trust. The effect of the tables on charitable lead annuity trusts is the opposite of the effect they have on charitable remainder annuity trusts. The charitable term will be more valuable at lower interest rates:

$100,000 Charitable Lead Annuity Trust, $6,000 Annuity
Value of Charitable Gift (Annuity Interest):

§7520

	10%	9%	8%	7%	6%	5%	4%	3%	2%	1%
10 yr. term	$36,868	$38,506	$40,261	$42,142	$44,160	$46,330	$48,665	$51,180	$53,895	$56,828
Life of Person Age 50	$53,380	$58,075	$63,565	$70,042	$77,058	$85,669	$89,526	$91,493	$92,732	$93,608

5. For charitable lead unitrusts for a fixed term of years, ignoring the small impact of the timing and frequency of payments, the change in the interest rates will have no effect, because the amount paid to the charitable beneficiary fluctuates with the value of the trust's assets.

I. Elimination of Use of "Ghoul" Trusts

1. On January 5, 2001, the Department of the Treasury announced final regulations to eliminate the use by planners of an aggressive form of charitable lead trust, sometimes referred to as a "ghoul" trust. In this charitable lead trust, taxpayers select as a measuring life an individual who is seriously ill but not "terminally ill" within the meaning of Section 7520 regulations. Because the individual is not "terminally ill," the charitable interest is valued based on the actuarial tables. When the seriously ill individual dies, the amount the charity actually receives will be less than the amount on which the gift or estate tax charitable deduction was based. This in turn makes the amount of the actual transfer to the remainder beneficiaries greater than the amount subject to gift tax. The Treasury Department believed that this scheme was abusive and consequently has issued amendments of Regs. § 1.170A-6, 20-2055-2, and 25-2522(c)-3.

2. Under these regulations, only the donor, the donor's spouse, a lineal ancestor of all the remainder beneficiaries, or a spouse of such lineal ancestor may be used as a measuring life. Otherwise a term of years must be used. The regulations apply to inter vivos transfers made on or after April 4, 2001 and to wills or revocable trusts where the decedent dies after that date.

XIII. **Public Charities**

A. All charities are classified either as a public charity or a private foundation. Preferential treatment, as discussed above, is given to public charities as well as to donors to public charities. As discussed in the next section, private foundations are subject to complex and restrictive rules.

B. Under IRC § 509, all charities are defined as a "private foundation" unless they meet certain tests that permit them to be classified as something other than a "private foundation."

C. There are three general categories of public charities.

1. Traditional Public Charities (IRC § 509(a)(1)). These include charities, such as churches, schools, hospitals or medical research organizations, and governmental units.

2. "Donative" or "Service Provider" Charities (IRC § 509(a)(2)). The regulations provide two tests for qualifications under this category. The first is the 33⅓% support test, which is the one most commonly used, and the second is the "facts and circumstances" test.

a. 33⅓% Support Test. An organization will be treated as meeting this test for the current taxable year and the immediately succeeding taxable year before the four taxable years immediately preceding the current taxable year, the organization receives more than 33⅓% of its support on an aggregate basis from the general public. In addition, no more than ⅓ of the support can come from gross investment income.

b. "Facts and Circumstances Test." Even if an organization fails to meet the 33⅓% support test, it will be treated as a publicly supported organization if it normally receives at least 10% of its total support from the general public and is organized and operated so as to attract new and additional public or governmental support. In addition, the following factors will be taken into account in determining whether the organization is publicly supported:

(1) The organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis;

(2) The higher public support is above 10%, the lesser the burden on the other factors;

(3) Representative sources of support rather than all from the members of a single family;

(4) Representative governing body; i.e., represents broad interests of the public; rather than the interests of a limited number of donors;

(5) Availability of public facilities or services;

(6) Whether solicitation of dues-paying members is designed to enroll a substantial number of people in the community or area or in a particular profession or field of special interest;

(7) Whether dues for individual members (rather than institutional) are designed to make membership available to a broad cross-section of the interested public;

(8) Whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose.

c. A Section 509(a)(2) charity must meet the following tests:

(1) Normally receives more than one-third of its support in each taxable year from any combination of:

(A) Gifts, grants, contributions, and membership fees; and

(B) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in an activity which is not an unrelated trade business, from any person or governmental bureau or agency to the extent that such receipts do not exceed the greater of $5,000 or 1 percent of the organization’s support during the taxable year;

from persons other than “disqualified persons”, from governmental units, or from Section 509(a)(1) organizations.

(2) Normally does not receive more than one-third of its support in each taxable year from the sum of

(A) Gross investment income; and

(B) The excess (if any) of the amount of unrelated business taxable income over the amount of tax imposed on such income.

(3) Support means the same as for 509(a)(1) organizations, except that is also includes gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business.

3. Supporting Organizations IRC § 509(a)(3). This is an organization that maintains an extremely close relationship with a publicly supported organization. They are frequently created by public charities for purposes of autonomy or limiting liability. There are essentially three types of supporting organizations.

a. "Operated, Supervised, Or Controlled By." This is an organization that is operated, supervised or controlled by the supported organization. The majority of the directors or trustees are appointed or elected by the supported organization. This is similar to the relationship between a parent and subsidiary. This is often referred to as a "Type I Supporting Organization."

b. "Supervised Or Controlled In Connection With." In this situation, there is common supervision or control over both the supporting and supported organizations. In addition, there must be provisions in place that ensure that the supporting organization will be responsive to the needs and requirements of the publicly supported organization. In practice, the same persons control or manage both the supporting organization and the supported organization. This is often referred to as a "Type II Supporting Organization."

c. "Operated In Connection With." In this situation, the control does not have to be given to the publicly supported charity. Instead, there must be significant involvement in the operation of the public charity and the public charity must be dependent on the supporting organization for support for one or more programs. This is often referred to as a "Type III Supporting Organization."

XIV. Private Foundations

A. Individuals with significant charitable inclinations may wish to establish a private foundation as a permanent vehicle for their charitable giving. A private foundation provides an individual with the maximum degree of control and flexibility with respect to use of his assets for charitable purposes, both during the individual's life and after his death.

B. A private foundation may be organized as either a corporation or a trust. Under either form, the individual who establishes the foundation can set forth his preferences for future charitable giving in as much detail as he desires. The individual can outline a comprehensive giving program for the foundation when he creates it, or leave decisions to the discretion of the foundation's governing body (*e.g.,* board of directors). The individual can retain this decision-making authority himself, and designate the person or persons who will have the authority after his death.

1. The individual should be aware that date-of-death value of assets that he transfers to a foundation will be included in his estate under section 2036 if he has the authority under the foundation's governing instrument to designate the charitable recipients of foundation gifts (Rifkind v. United States, 84-2 USTC ¶ 13,577 (U.S. Ct. Cl. 1984)).

2. Although the individual's estate will receive a corresponding charitable deduction for the foundation assets if it has qualified as a charitable organization, inclusion of the assets in the estate may affect the calculation of the marital deduction or the estate's ability to use IRC § 303 or § 6166.

C. If the foundation has the appropriate charitable purposes, it can obtain federal tax-exempt status from the IRS by filing a Form 1023, Application for Recognition of Exemption. If an exemption is granted, donations to the foundation will be deductible for income, gift, and estate tax purposes.

1. As discussed in the percentage limitation section of this outline, the income tax deduction for contributions to a private foundation is subject to certain limitations. In most cases, a private foundation established by an individual will be a nonoperating foundation and will therefore be treated as a 30-percent-type organization. Generally, only the basis of appreciated property donated to the foundation may be deducted, except for "qualified appreciated stock," the fair market value of which may be deducted, subject to a 20% limitation.

2. Subject to certain minimum annual distribution requirements (IRC § 4942), the foundation can hold property contributed to it indefinitely, as long as the property ultimately is distributed to charitable organizations or for charitable purposes.

3. Except for an annual 2 percent excise tax on the foundation's net investment income (IRC § 4940(a)) and a tax on any unrelated business taxable income (IRC § 511), the foundation should be exempt from income tax.

4. As noted above, a foundation (like a public charity) can obtain tax-exempt status from the IRS by filing a Form 1023, Application For Recognition of Exemption.

   a. If the Form 1023 is filed within 15 months after the end of the month in which the organization was organized then the private foundation is exempt from the date of creation.

b. If the Form 1023 is filed after the 15 month period, then the private foundation will be exempt only from the date of filing.

c. The date that a foundation is organized depends upon the type of trust.

(1) Split interest trust - the date of termination of the last private income interest. An example of this is a charitable remainder trust that is designed to become a private foundation upon the death of the grantor who until then has had the unitrust or annuity interest;

(2) Wholly charitable testamentary trust - the date of death; and

(3) Wholly charitable inter vivos trust - the date of creation.

d. A Form 8718, User Fee for Exempt Organization Determination Letter Request, and payment of the fee, is sent in with the Form 1023. Currently, the fee is $150 for organizations with gross receipts of $10,000 or less, and $500 if annual gross receipts have or will exceed $10,000.

D. Because of past abuses of private foundations, they are now subject to numerous restrictive excise taxes and regulations. In general, these laws and regulations ensure that the foundation is used to further charitable purposes rather than to benefit the individual who established the foundation or his family (see IRC §§ 4940-4946 and the regulations thereunder). They do not interfere with the operation of a foundation that has been created by someone with purely philanthropic intentions. However, because of the rather complex reporting requirements imposed by the Internal Revenue Code and regulations, together with registration and financial reporting requirements often imposed by state law, usually only individuals who are willing to commit substantial resources to charitable endeavors conclude that a foundation is an appropriate vehicle.

1. Excise Tax on Net Investment Income (IRC § 4940). A two percent excise tax is imposed on a private foundation's net investment income. Generally, net investment income means the excess of gross investment income and net capital gains from the sale or other disposition of property held for investment purposes over the ordinary and necessary expenses paid or incurred for the production of such income. Note that the tax applies to both ordinary income and capital gains. The excise tax may be reduced from two percent to one percent if certain defined distribution requirements are met.

2. Tax on Self-Dealing Transactions (IRC § 4941). A tax is imposed on acts of self-dealing between a foundation and disqualified persons. The

following types of transactions are prohibited between the donor or other disqualified person and the foundation:

a. Sale, exchange or leasing of property.

b. Lending of money.

c. Furnishing of goods, services or facilities. The furnishing of goods, services or facilities by disqualified persons to a private foundation is not an act of self-dealing if they are furnished without charge.

d. Payment of compensation or reimbursement of expenses unless such amounts are reasonable and necessary to carrying out the foundation's exempt purposes and are not excessive.

3. Tax on Failure to Distribute Income (IRC § 4942). Essentially a foundation must distribute five percent of the foundation's assets each year. However, the only assets subject to the minimum investment return computation are investment assets. Assets held or used directly in carrying out a foundation's exempt purpose are not subject to the computation. For example, in Rev. Rul. 82-132, 1982-2 C.B. 303, a private foundation owned a building, a portion of which was used directly as offices in carrying out its exempt purposes. The remainder was leased to commercial tenants. The percentage of exempt use of the building for purposes of determining the foundation's minimum investment return was determined by dividing the fair rental value of the portion used for exempt purposes by the fair rental value of the entire building.

4. Tax on Excess Business Holdings (IRC § 4943). The Code places percentage limitations on the business holdings that a private foundation may have in a business enterprise. The term “business enterprise” includes corporations and unincorporated business activities. Permitted holdings of a private foundation are limited to twenty percent of the voting stock of a corporation, reduced by the percentage of such stock held by all of its disqualified persons. The maximum aggregate percentage is increased to thirty-five percent when third persons have effective control of the corporation. A foundation is allowed a five year retention period after acquisition of an excess business holding. The five year retention period may be extended for an additional five years in the case of an unusually large gift or bequest of diverse holdings with complex corporate structures if the IRS approves.

5. Tax on Investments Which Jeopardize the Charitable Purpose (IRC § 4944). Section 4944 imposes a tax on the making of an investment by a private foundation in such a matter as to jeopardize the carrying out of any of its exempt purposes. While no category of investments is treated as a

per se violation, the following are types of investments that will be closely scrutinized. These include trading in securities on margin, trading in commodity futures, investment and working interest in oil and gas wells, the purchase of “puts,” “calls” and “straddles,” the purchase of warrants, and selling short. (Treas. Reg. § 53-4944-1(a)(2). One significant exception to IRC § 4944 is for investments, the primary purpose of which is to accomplish one or more of the organization's exempt purposes and no significant purpose of which is the production of income or the appreciation of property. This type of investment, known as a “program-related investment,” is not considered an investment that could jeopardize the carrying out of exempt purposes.

6. Tax on Taxable Expenditures (IRC § 4945). Section 4945 imposes a tax on certain types of “taxable expenditures.” These include any amount paid to carry out propaganda or otherwise to influence legislation other than making available the results of nonpartisan analysis, study, or research. There is an exception for appearances before a legislative body with respect to a possible decision that might affect the existence of a private foundation, its powers and duties, its tax exempt status or the deductibility of contributions to a foundation. Taxable expenditures also include any amount paid by a private foundation to influence the outcome of any specific legislation or to carry on a voter registration drive. In addition, taxable expenditures include any amount paid or incurred by a private foundation as a grant to an individual for travel, study or similar purposes unless the grant is awarded on an objective and nondiscriminatory basis pursuant to a procedure approved by the IRS in advance. The requirements of a proper procedure for grant approval are set forth in Treas. Reg. § 53-4945-4(c).

7. The following chart shows the different taxes imposed on private foundations.

Private Foundation Taxes

IRC Section		First Tier Tax	Second Tier Tax
4940	Tax on Net Investment Income	2%[1]	
4941	Tax on Self-Dealing	10% of amount involved	200% of amount involved if not corrected within close of taxable period
4942	Tax on Failure to Distribute Income	30% of undistributed amount	100% of undistributed amount if not corrected before the close of the taxable period
4943	Tax on Excess Business Holdings	10% of value of excess business holdings on that day in a taxable year when the foundation's holdings in a particular business enterprise are the greatest	200% of value of excess business holdings if not disposed of before the close of the taxable period
4944	Tax on Jeopardizing Investments	10% of amount of jeopardizing investment	25% of amount of jeopardizing investment if not corrected within the taxable period
4945	Tax on Taxable Expenditures	20% of amount of the taxable expenditure	100% of taxable expenditure if not corrected by close of taxable period

[1] Reduced to 1% if large enough distributions are made each year.

E. The basis limitations on the income tax charitable deduction for contributions of appreciated assets to a private foundation do not apply to gifts to public charities. There are a number of types of charitable organizations which are completely or largely privately controlled but which qualify as public charities. A donor may be interested in using one of these types of organizations to obtain a greater income tax deduction if he intends to gift appreciated assets. These organizations will permit the donor to maintain a high level of participation in decisions related to the use of the funds.

1. Creation of private operating foundation. One solution to the limitations on the income tax charitable deduction is to create a private operating foundation. A private operating foundation devotes a portion of its efforts and assets to engaging directly in charitable activities, such as operating a homeless shelter, making education films, or operating a park open to the public. There are several tests for determining whether a foundation may obtain private operation foundation status, but a foundation that spends a large percentage of its adjusted net income on direct charitable activities typically would qualify.

   a. Many charitably minded individuals do not want to operate direct charitable activities over the long term. They would rather use the foundation to make gifts to other public charities. They still may wish to create a private operating foundation if they plan a significant gift of appreciated assets, so that they can obtain an income tax deduction for the full fair market value of those assets. In the year after the donation, they can switch to making normal charitable gifts. At that point, the foundation's status will revert to that of a regular private foundation, but this will not affect the income tax deductibility of the gift in the preceding year. This technique is sometimes referred to as a MINIPOOF for "Minimum Term Private Operating Foundation."

   b. The actual amount of foundation property that must be used in direct charitable activities can be quite small. The individual can designate the tax year of the foundation so that its initial year will be less than one year. (For example, designate a tax year ending August 31, 2001 for a foundation created on January 1, 2001.) Because the income in that first tax year will be minimal, the percentage that must be devoted to charitable activities will also be small. After a minimal expenditure for direct charitable activities in the first two months, the foundation can thereafter operate as a grant-making foundation.

2. Other solutions include the creation of a "donor advisory account" at a local public charity or community trust or a support organization connected to a specifically identified public charity.

F. Public Disclosure Rules. The 1998 Tax Act modified IRC § 6104 to extend to private foundations the same rules regarding public disclosure of annual information returns that apply to public tax exempt organizations. Section 6104(d) requires public disclosure of all the information contained in an application for exemption and in any annual information return filed. For a private foundation, this includes disclosure of the names and addresses of contributors to the foundation. The foundation must make copies of documents available to anyone upon request. The regulations provide an exception for documents that are made widely available by posting them on the Web. The widely available exception no longer is satisfied by filing the documents with a state agency that makes them available and then publishing notice.

G. Estimated Taxes. Private foundations must make estimated tax payments of the IRC § 4940 excise tax on net investment income the tax exceeds $500 annually. The payments must be made by the fifteenth day of the fourth, sixth, ninth, and twelfth months of the fiscal year.

H. Relative Advantages and Disadvantages.

1. Advantages of a private foundation over a public charity.

a. Flexibility--charity does not have to be named.

b. Easier to qualify as tax-exempt.

c. Control does not have to be relinquished.

d. No need to maintain a close working relationship with any one charity.

2. Advantages of a public charity over a private foundation.

a. Ease of administration.

(1) No prohibited transactions.

(2) No excise tax on net investment income.

(3) No minimum investment return.

b. Higher charitable deduction limits.

c. Simpler tax returns.

d. No estimated tax payments.

XV. Charitable Gift Annuities

A charitable gift annuity involves a transfer of cash or other property to a charity in exchange for the charity's commitment to pay the donor, another party (such as a spouse), or both, a fixed and guaranteed annuity for life. The transferor may claim a charitable deduction equal to the value of the property transferred, less the fair market value of the annuity.

A. Income Taxation

1. Charitable gift annuities are generally taxed when established under the bargain sale rules. As mentioned, a charitable deduction is allowed in the

year of the transfer for the difference between the present value of the annuity contract and the value of the property contributed (Treas. Reg. § 1.170A-1(d)). The value of the annuity contract for these purposes is determined on the basis of the Treasury valuation tables.

2. As with a bargain sale, the donor must allocate his basis in the transferred assets between the sale portion and the gift portion, and the donor may realize gain on the sale portion. However, if the annuity is non-assignable and the donor is either the sole annuitant for life or is one of the annuitants in a two-life annuity, any capital gain is recognized ratably over his life expectancy (Treas. Reg. § 1.1011-2(a)(4)(ii)). Any unrecognized gain at the donor's death is not reportable if the annuity is a single life annuity. If the annuity pays over two lives, the succeeding annuitant continues to recognize any remaining gain under the same rules.

3. The annuity payments are taxed to the annuitant when received under IRC § 72. Under that section, an "exclusion ratio" is determined based on the ratio of the investment in the contract (i.e., its fair market value at inception) to the total expected return under the annuity (the annual annuity multiplied by the annuitant's life expectancy), in each case determined under Treasury Department tables (Treas. Reg. § 1.72-9). The annuitant applies the exclusion ratio to each payment to determine how much thereof is a tax-free return on investment and how much is taxed as ordinary income.

B. Gift and Estate Taxation

1. If the donor names someone other than himself as an annuitant, the donor makes a gift to that person. If the annuity payments to the third party are to begin immediately (i.e., a single-life annuity), the gift will be one of a present interest qualifying for the gift tax annual exclusion. A gift annuity to the donor's spouse will qualify for the gift tax marital deduction (Treas. Reg. § 25.2523(b)-1(b)(6)(ii)). If the donor is the initial recipient of the annuity payments and payments to the donee will begin in the future if the donee survives the donor-annuitant, the annual exclusion will not be available. However, if the survivor annuitant is the donor's spouse, the gift tax marital deduction will be available (IRC § 2523(f)(6)).

2. If the donor is the sole annuitant of a single-life annuity, no amount is includable in his estate at death. If the annuity is payable to the donor and then to a survivor-annuitant after the donor's death and the donor predeceases the survivor-annuitant, an amount is includable in the donor's estate equal to the value of a commercial annuity which pays the same amount to the survivor-annuitant (IRC § 2039(a)).

3. If a testator directs by will that his executor establish a charitable gift annuity for another, an estate tax charitable deduction will generally be

allowed for the difference between the amount transferred to the charity and the present value of the annuity contract (computed in the same manner as for inter vivos arrangements). Because the estate receives a stepped-up basis in the transferred assets, usually no capital gain should result. Finally, if the testator's spouse is the annuitant, the spouse's interest may qualify for the QTIP marital deduction election (Treas. Reg. § 20.2056(b)-7(c)(2)).

C. Examples of Single Life and Joint Lives Charitable Gift Annuities

EXAMPLE: Donor, age 65, establishes a charitable gift annuity in December 2014 at the University of Virginia School of Law with $100,000. For the rest of his or her life, Donor will receive an annual payment from the University of Virginia School of Law of $4,700 or 4.7% (the percentage recommended by the American Council on Gift Annuities) of the original amount with which the charitable gift annuity was funded. Upon Donor's death, whatever is left in the gift annuity account will pass to the University of Virginia School of Law. Upon funding, Donor receives a $26,900 income tax charitable deduction.

EXAMPLE: Husband, age 65, and Wife, age 62, establish a charitable gift annuity in December 2014 at the University of Virginia School of Law with $100,000. Until the death of the second of Husband and Wife to die, an annual payment of $4,100 or 4.1% (the percentage recommended by the American Council on Gift Annuities) of the original amount with which the charitable gift annuity was funded will be paid by the University of Virginia School of Law to Husband and Wife or the survivor. Upon the death of the survivor, whatever is left in the gift annuity account will pass to the University of Virginia School of Law. Upon funding, Husband and Wife receive a $15,400 income tax charitable deduction.

XVI. Gift of Remainder Interest in Personal Residence or Farm

A. A charitable deduction is allowed for income, estate and gift tax purposes for a charitable gift of a donor's personal residence or farm, even though the donor retains an estate in the property for life or for a term of years. The donor may either retain a life estate or give one to others, and the life estate may include one or more lives (IRC § 170(f)(3)(B); Treas. Reg. § 1.170A-7(b)(3) and (4)).

B. In valuing the allowable income tax charitable deduction for the remainder interest, one must factor in depreciation (computed on a straight-line method) and depletion of the donated real estate. The resulting value is then further discounted under the Treasury Department tables (Treas. Reg. §§ 1.170A-7(c); 1.170A-12).

C. For gift and estate tax purposes, depreciation or depletion need not be taken into account. The terms "personal residence" and "farm" do not include household furnishings or other tangible personal property, and no deduction is allowed for a gift of a remainder interest in such items.

D. Gift Taxation

1. A gift of a remainder interest to charity with a life estate reserved for a beneficiary other than the transferor results in a gift to the life beneficiary equal to the value of his or her life interest, determined under Treasury Department valuation tables. The life interest is a present interest and qualifies for the gift tax annual exclusion. If life tenant is the transferor's spouse, the entire value of the property will qualify for the QTIP marital deduction election. At the spouse's death, her estate will receive a charitable deduction for the full value of the property (IRC §§ 2044, 2055).

2. A gift of a remainder interest to charity where the transferor reserves a life estate for himself and then for the life of another results in a future interest gift to the successor beneficiary of his or her life interest. The gift will not qualify for the gift tax annual exclusion, as it is not a present interest. However, the transferor can avoid making a gift to the successor beneficiary if the transferor reserves the right to revoke the successor's interest, without affecting the charitable gift (Treas. Reg. § 25.2511-2(c)). If the transferor exercises that right, the transferor should then receive an additional income tax charitable deduction for the then-current value of the successor's survivorship interest. If the successor beneficiary is the transferor's spouse, it appears that her interest will not qualify for the gift tax marital deduction, since her interest is contingent and begins in the future.

E. Estate Taxation

1. In the case of a gift of a remainder interest to charity with a life estate reserved for the transferor's life, the full fair market value of the property is included in the transferor's estate at death (IRC § 2036). However, the estate will receive an offsetting estate tax charitable deduction (IRC § 2055).

2. When the transferor makes a lifetime gift of a remainder interest to charity with a life estate reserved for a beneficiary other than the transferor, he has transferred the entire property for gift tax purposes and no part of it is included in the transferor's estate at his death. For a lifetime gift of a remainder interest to charity where the transferor reserves a life estate for himself and then for the life of another, the entire property again is included in the transferor's estate at death.

3. If the successor life tenant survives the transferor, the value of the charitable remainder is nevertheless deductible in the transferor's estate; only the surviving life tenant's interest is subject to tax.

4. If the surviving life tenant is the transferor's spouse, the full value of the property should qualify for the QTIP marital deduction election in the transferor's estate. At the surviving spouse's death, her estate will then receive a charitable deduction for the property.

5. The IRS has ruled that gifts of remainder interests in a personal residence or farm must be in the property itself; they cannot be in the proceeds from the sale of the property. Thus, where a testator's will directs that the property be sold at the life tenant's death and that charity receive all or a part of the proceeds, no deduction is allowed (Rev. Rul. 77-169, 1977-1 C.B. 286; Rev. Rul. 76-543, 1976-2 C.B. 287). The Tax Court has reached the opposite result, however, in a situation in which the charity had the power under applicable state law to require distribution of the residence in kind instead of taking the sale proceeds (Blackford v. Comm'r, 77 T.C. 1246 (1981)). The IRS has acquiesced in the result of this case (Rev. Rul. 83-158, 1983-2 C.B. 159).

XVII. **Gift of an Undivided Interest in Property**

A. A charitable deduction is allowed for a gift of an undivided portion of a donor's entire interest in property. The gift must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in the property and it must extend over the entire term of the donor's interest (IRC § 170(f)(3)(B); Treas. Reg. § 1.170A-7(b)(1)). The following are examples of gifts of an undivided interest:

1. A fractional or percentile interest in a life estate in real property in which the donor owns no other interest.

2. A fractional or percentile share of a remainder interest in a trust in which the donor holds no other interest.

3. 50 acres of a donor's 100-acre farm.

4. An open space easement in gross in perpetuity.

5. Property where the charitable donee is given the right, as tenant in common with the donor, to possession, dominion and control of the property for a portion of each year appropriate to the donee's interest in the property.

B. A donor can give a charity both a remainder interest and an undivided interest in the same personal residence or farm, for example, by deeding his personal residence to charity reserving the right for life to use the property during part of the year as a vacation home (Rev. Rul. 76-473, 1976-2 C.B. 306). The donor will be entitled to a charitable deduction both for the value of the remainder interest and for the undivided portion of his life interest so donated.

C. An undivided interest is also a good means of obtaining an immediate charitable deduction for a gift of a partial interest in tangible personal property. Thus, an art collector can contribute a fractional interest in his collection to a museum, retaining possession of the collection for a portion of each year equal to the fraction of ownership retained.

XVIII. Qualified Conservation Contributions

A. A gift of a partial interest for conservation purposes which meets the definition of a “qualified conservation contribution” will also be eligible for a charitable deduction (IRC § 170(f)(3)(B)).

1. The 2006 Pension Protection Act increased the percentage limitation for certain gifts of qualified conservation contributions from 30 percent to 50 percent of adjusted gross income and increased the carryover from five to 15 years.

2. In the case of a farmer or rancher, a qualified conservation contribution deduction is allowable up to 100 percent of the taxpayer’s contribution base as long as the property is restricted in such a manner that the property remains available for farming or ranching purpose.

3. Both corporate and noncorporate farmers and ranchers also have a 15-year carryover.

4. An eligible farmer or rancher means a taxpayer other than a publicly traded C corporation whose gross income from the trade or business of farming is greater than 50 percent of the taxpayer’s gross income for the tax year.

5. These rules generally apply to contributions made in taxable years beginning after 2005.

B. The donated interest must be the donor’s entire interest in real property (other than mineral interests), a remainder interest in the property, or a perpetual restriction on the use of property.

C. A donor makes a qualified conservation contribution by donating one of these interests in perpetuity to a governmental unit or a public charity for various conservation purposes that benefit the general public, such as (i) preservation of land areas, (ii) protection of a natural wildlife habitat, (iii) preservation of open space, or (iv) preservation of historically important land areas or historic structures.

D. Estate Tax on Land with Qualified Conservation Easement. The 1997 Tax Act adds a provision that permits an estate to reduce the estate tax value of certain real estate subject to a qualified conservation easement.

1. Under current law, a deduction is allowed for federal gift and estate tax purposes for a contribution of a qualified real property interest (defined in Section 170(h)(2)(C)) to a charity or other qualified organization for conservation purposes.

2. Under the Act, an additional benefit is permitted with respect to certain real property that is includable in a decedent's gross estate, but that is subject to a qualified conservation easement. Under redesignated Section 2031(c), an executor may elect to exclude as much as 40 percent of the value of such property from the decedent's gross estate, if the following requirements are satisfied:

   a. The property has been owned by the decedent or a member of the decedent's family at all times during the three-year period immediately preceding the decedent's death; and

   b. A qualified conservation contribution of a qualified real property interest was made by the decedent or a member of the decedent's family to a charity or other qualified organization.

3. The amount of the exclusion is calculated based upon the value of the land *after* taking into account the conservation easement. In addition, two other factors may limit the value of the exclusion:

   a. First, if the value of the conservation easement is less than 30 percent of the value of the property taken as a whole (i.e., without taking into account the easement), then the percentage that may be excluded from the gross estate will be reduced below 40 percent. The statute provides that the 40 percent "applicable percentage" will be reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the easement is less than 30 percent of the value of the property taken as a whole. Thus, for example, if the value of the conservation easement equals 25 percent of the value of the entire property, then the exclusion limitation would be reduced by 10 percent [(30 percent - 25 percent) x 2] from 40 percent to 30 percent.

   b. In addition, the amount of the exclusion is subject to an "exclusion limitation," which will be phased in pursuant to the following table:

Year of decedent’s death	Exclusion limitation
1998	$100,000
1999	200,000
2000	300,000
2001	400,000
2002 and beyond	500,000

4. The qualified conservation easement exclusion under redesignated Section 2031(c) will apply to decedents dying after December 31, 1997.

5. The 1998 Tax Act made two changes.

   a. The election to reduce the estate tax value of certain real estate subject to a qualified conservation easement must be made on or before the due date (including extensions) for the filing of the federal estate tax return. (Section 2031(c)(6)).

   b. The estate tax deduction is available for a qualified conservation easement contributed after a decedent's death. Neither the estate on heirs will get an income tax deduction for the post-mortem gift. (Section 2031(c)(9)). However, the tax benefits of the estate tax deduction could outweigh any potential loss to the heirs because of a reduced value for the property. In estates with appropriate real property, the benefits and detriments of a qualified conservation easement should be assessed.

XIX. Non-Exempt Charitable Trusts

A. A non-exempt charitable trust is a trust that has not obtained an exemption from tax under Section 501(a) of the Code, that is solely for the benefit of one or more charitable organizations or charitable purposes, and for which a charitable deduction has been allowed under one or more of Section 170, 642(c), 2055, 2522, or other less common charitable deduction Code Sections. See IRC § 4947(a).

B. Non-exempt charitable trusts often are very old trusts, many of which at one time had one or more noncharitable income or annuity beneficiaries who have since died. Prior to the 1969 legislation that introduced much of the current regulatory scheme for charitable entities, it was not uncommon to simply create a trust that paid income to charity indefinitely. A taxpayer occasionally may come up with the idea today, as what he or she perceives to be a simple way to carry out long-term charitable support.

C. Basic fiduciary income tax principles suggest that such charitable trust would report like any other taxable trust, using a Form 1041. It would report its taxable income but would be able to claim an unlimited charitable deduction for its income paid to charity pursuant to Section 642(c). For pre-1969 trusts, it would appear they also would be able to claim a charitable deduction set-aside for capital gain. See IRC § 642(c)(2).

D. These types of trust in reality are subject to many of the same regulatory provisions as Section 501(c)(3) organizations. In the Tax Reform Act of 1969, Congress specifically included non-exempt charitable trusts in the regulatory scheme.

1. Unless the trust qualifies for another status, it is treated as a private foundation and will be subject to all the regulatory and excise tax provisions applicable to private foundations under Section 4949 to 4945 of the Code.

2. If the trust does not meet the requirements of Section 508(e) of the Code, which requires private foundations to make distributions in compliance with the minimum distribution rules of Section 4942 and to contain prohibitions in compliance with Sections 4941, 4943, 4944 and 4945, then pursuant to Section 642(c)(6), the charitable deduction rules of Section 170 will apply to the trust rather than Section 642(c). See Treas. Reg. § 1.642(c)-4. The main consequence of this provision is to limit the trust's charitable deduction to 50% (or in some cases 30%) of its adjusted gross income.

E. Tax Reporting. A non-exempt charitable trust is supposed to file a Form 1041 for the year if it has taxable income. In addition, it is treated as a private foundation, it is supposed to file a Form 990-PF.

F. A non-exempt charitable trust may apply for determination of a status other than as a private foundation, and request that a favorable determination apply retroactively to the date the trust became a non-exempt charitable trust. See Rev. Proc. 72-50, 1972-2 C.B. 830, as modified by Rev. Proc. 76-34, 1976-1 C.B. 656.

1. Some trusts can qualify as a Type III supporting organization under Section 509(a)(3). This allows the trust to avoid the regulatory requirements of Sections 4940 to 4945.

2. The regulations under Code Section 509(a)(3) contain two separate tests for qualifying as a Type III supporting organization – the "responsiveness test" and the "integral part test."

3. The responsiveness test is designed to show that the supporting organization is responsive to the needs or demands of the supported organization. One way to satisfy this test is by showing that officers or directors of the supported organization have a significant voice in operating and governance of the trust. Even if this is not the case, however, a charitable trust under state law can satisfy the test if each

supported organization is a named beneficiary under the trust instrument and has the power to enforce the trust and compel an accounting under state law.

4. The integral part test requires establishing that the supporting organization maintains a significant involvement in the operating of the supported organization, and that the supported organization is dependant upon the supporting organization for the type of support it receives. This test can be satisfied if the trust is required to distribute all or substantially all of its income to one or more supported organizations, and the amount of support received is sufficient to insure the "attentiveness" of the supported organization or organizations. This latter test is a facts and circumstances test, with the level of support being provided in general or for a particular program being a key factor.

XX. **Conclusion**

With creative counsel, the charitably minded client can achieve significant financial and planning benefits from his charitable giving.

Security National Bank

Ethical Issues with Respect to Closely Held Businesses

Monday, October 15, 2018
11:30 a.m. – 12:30 p.m.

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The McGuireWoods Private Wealth Services Group

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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Ethical Issues with Respect to Closely Held Businesses

I. INTRODUCTION[1]

A. Many ethical issues arise in the life cycle of a closely held business from inception to end. Some of the areas to be examined are competence, timeliness of work, keeping the client informed, and the conflicts that can arise in representing more than one party involved in the business, or representing the organization as a client.

B. These materials will look at these issues through the prism of the ethical rules governing lawyers. The ethical conduct of almost all lawyers is governed by some version of the American Bar Association's *Model Rules of Professional Conduct* (Model Rules).[2] In examining ethical issues confronting estate planning lawyers, one place of inquiry for each issue will be the Model Rules and Comments to the Model Rules. A second basic and valuable reference for examining the ethical issues facing estate planning lawyers is the *ACTEC Commentaries on the Model Rules of Professional Responsibility* (ACTEC Commentaries).[3] As noted in the Preface to the ACTEC Commentaries, the Model Rules and Comments to the Model Rules often fail to provide sufficient guidance to lawyers engaged in an estate planning or related practice. The purpose of the ACTEC Commentaries is to help provide the guidance estate planners need in understanding their professional responsibilities. This has also been noted in various articles and other publications. For example in 1993, Malcolm A. Moore and Anne K. Hilker wrote: "For some time, estate planners have been hampered by inadequate guidance from the ABA Model Rules of Professional Conduct and other available guidelines. Promulgated in 1983, the Model Rules recognized that the lawyer may not always be an adversary but rather may serve as counselor. However, the commentary to those Rules did not provide extensive guidance on the

[1] Skip Fox's former colleague, Kurt Friesen, provided invaluable help in putting an earlier version of these materials together. These materials are also based in part on an update of "Is Crossing State Lines Ethically Challenging to Estate Planners" presented at the 1999 Institute and "The Top Ten Ethical Challenges For Estate Planners and Professionals Today and the Best Practices for Addressing Them" presented at the 2008 Heckerling Institute by Skip Fox. Finally, portions of these materials are derived from materials prepared by Skip Fox's colleague Thomas E. Spahn, a true expert on ethical issues facing lawyers.

[2] To date, California is the only state that does not have professional conduct rules that follow the format of the ABA Model Rules.

[3] American College of Trust and Estate Counsel (Fifth edition 2016).

handling of day-to-day communications between parties and counsel in estate planning."[4]

C. While this paper is focused on the ethical consequences to lawyers, the discussion is equally relevant to practitioners in other fields. Other fields have their own rules of professional responsibility. Even if an estate planning professional does not face disciplinary penalties, a dissatisfied client could bring a malpractice action for damages. One possible way of looking at this is that the ethical rules, possible disciplinary sanctions, and the possible awards of monetary damages to former clients for malpractice are intertwined. The ethical rules provide a goal to which lawyers and other estate planning professionals should aspire in order to meet the needs of their clients. The threat of a malpractice claim is the stick that encourages estate planning lawyers and others to meet their professional responsibilities. Failure to do so may result not only in a disciplinary sanction but in the need to compensate a client for that failure. By understanding the ethical rules and seeking to meet their requirements, estate planning lawyers and others should be able to mitigate or avoid the potential negative consequences that could otherwise arise.

II. COMPETENCE

A. Basic Considerations.

1. Every lawyer, no matter what type of matter in which he or she is representing a client, must provide competent representation.

2. Inadequate or incompetent representation of a client (or clients) potentially exposes a lawyer to more than simply a malpractice complaint. It can also result in sanctions imposed by the lawyer's state bar. Representation of multiple family members in an estate planning transaction increases the likelihood that a malpractice claim or complaint with a state bar will be made, if only because such representations are more likely to result in at least one dissatisfied client, especially when the transaction does play out as every family member thought that it would.

B. Model Rule 1.1

1. Model Rule 1.1 relates to the competence of counsel and states as follows:

> A lawyer shall provide competent representation to a client. Competent representation requires the legal

[4] Malcolm A. Moore & Anne K. Hilker, "Representing Both Spouses: The New Section Recommendations", Prob. & Prof. July/Aug. 1993, at 26, 26.

knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

2. This rule is of particular importance to estate planning practitioners, whose practices often involve many different areas of the law, including trust and estate administration, tax law, corporate law, partnership law, insurance law, employee benefits, elder law, investment real estate law, and litigation. For example, one transaction, such as the formation of a limited liability company to hold marketable securities and commercial real estate with family members as the members of the limited liability company and then having the family members transfer their limited liability company interests to a revocable or irrevocable trust, can involve complex questions of partnership, trust, contract, real estate, and tax law. Importantly, Comment 1 to Model Rule 1.1 authorizes a lawyer to obtain the requisite knowledge and skill in a particular matter through preparation and study if the lawyer lacks the necessary knowledge and skill. Of course, this does not address whether the lawyer may charge the client for the necessary study and preparation.

C. ACTEC Commentary – Model Rule 1.1.

1. The ACTEC Commentary notes and lists several areas with respect to a lawyer's competence to represent a client in a particular matter. Given the complexity of some estate planning with respect to intra-family transfers, competency is a critical consideration.

a. Meeting the needs of the client.

(1) One important question is whether the lawyer must have a thorough understanding of all the different rules that might affect a transaction in order to have the necessary competence to represent one or more clients in a particular transaction.

(2) The ACTEC Commentary also suggests that the needs of a particular client may be met through additional research and study when a lawyer represents the client and initially lacks the skill or knowledge required to meet those needs.

(3) The needs of the client may also be met by involving another lawyer or professional with the requisite skill or knowledge. In order to maintain confidentiality, another lawyer should only be

consulted on an anonymous basis, or on a confidential basis with the consent of the client.

(4) The lawyer should be upfront with the client about his or her level of expertise.

b. A mistake in judgment does not necessarily indicate a lack of competence. According to the ACTEC Commentary, a mistake in judgment does not necessarily indicate a lack of competence. It notes that a lawyer might not precisely assess the tax or substantive law consequences for a particular transaction for a variety of reasons. These include unclear facts, disputed facts, or the unsettled state of the law. The complexity of a transaction or its unusual nature or its novelty may prevent a competent lawyer from accurately assessing the treatment of a particular transaction for tax or substantive law purposes. Of course, clients may disagree with this, especially with the advantage of hindsight.

c. Importance of facts. Clients need to provide their lawyers with accurate facts. A failure to do so can cause bad advice to be given. The ACTEC Commentary indicates that a lawyer may rely upon information provided by a client unless the circumstances indicate that the information should be verified.

d. Supervising execution of documents. The ACTEC Commentary to Model Rule 1.1 states that a lawyer who prepares estate planning documents for a client should supervise their execution. If it is not practical for the lawyer to supervise the execution, the lawyer may arrange for the documents to be delivered to the client with written instructions regarding the manner in which the documents should be executed. The lawyer should do so only if the lawyer reasonable believes that the client is sufficiently sophisticated and reliable to follow the instructions and there are no concerns about potential challenges.

e. Competence requires diligence in communications with the client. Competence requires that a lawyer handle a matter with diligence and keep the client reasonable informed during the active phase of a representation. This is discussed in Model Rules 1.3 (Diligence) and 1.4 (Communications).

f. Competence with technology. The ACTEC Commentary notes that a lawyer who uses technology to transmit or store client documents or who communications electronically with a client regarding the drafting of documents must be aware of the potential effects of such use of technology on client confidentiality and the preservation of client information. The lawyer must stay reasonably informed about developments in technology used in client communications and document storage, including improvements, discoveries of risks and best practices.

D. Cases on Competence

1. Case law regarding the competence of estate planning lawyers demonstrates that claims based on a lack of competence can be brought not only by the lawyer's client, but perhaps by beneficiaries of a client's estate plan as well. This ability of a beneficiary to sue a lawyer will often depend upon state law.

2. In Sindell v. Gibson, Dunn & Crutcher[5], the court held that the intended beneficiaries of an estate plan prepared for the beneficiaries' father suffered "actual injury" in defending a lawsuit by the surviving spouse's conservator that plaintiffs alleged would not have been filed but for the law firm's negligence.

a. In Sindell, Harold Caballero retained Gibson, Dunn & Crutcher to prepare his estate plan so as to transfer wealth to his daughters and his daughters' children.[6] Knowing that all of Mr. Caballero's wealth was in a ranch he owned and controlled, his lawyers advised him to make gifts and sales of interests in the business to the children and the grandchildren.[7] Mr. Caballero's wife was not the mother of his children, and she had children of her own from a prior marriage. In addition to having substantial assets of her own and her own lawyers, under California law, the wife had a community property interest in Mr. Caballero's ranch. The court found that at the time that the testator implemented his estate plan, his wife would have been willing and able to execute a waiver of her community

[5] 63 Cal. Rptr. 2d 594 (Cal. Ct. App. 1997)

[6] 63 Cal. Rptr. 2d at 596.

[7] *Id.*

property rights in the ranchland, although none was obtained.

b. The wife subsequently became incompetent and the wife's children sued Mr. Caballero for the amount of his wife's community property interest in the business. While this action was pending, Mr. Caballero's children and grandchildren sued Gibson, Dunn & Crutcher (1) to indemnify them for the amounts that they stood to lose in the action initiated by the wife's children, (2) for the $50,000 fee paid to the lawyers for the estate plan, and (3) for other expenditures associated with the plan. Although the decision turned on what event constitutes the actual injury in a legal malpractice action, the court held that the failure to obtain the written waiver from the wife clearly constituted negligence. In so finding, the court noted:

> The failure of the defendants to obtain the readily available evidence of [the wife]'s consent to those transactions, or acknowledgement as to the separate nature of the property involved, was below the standard of care in the community and constituted negligence by the defendants. In short, the defendants breached their duty of care by failing to secure the [the wife]'s consent prior to the time that she fell ill and became mentally incompetent to give it.[8]

3. In Kinney v. Shinholser,[9] one lawyer drew a will for a married client which failed to preserve the tax benefit of the testator's unified credit. Instead, the will gave the entire estate to a trust for the benefit of the widow over which she was given a general power of appointment. As a result, the widow's estate at her subsequent death would be required to pay estate taxes that would have been avoidable if the widow had not been given a general power of appointment. The decedent's son sued the draftsperson who prepared the will and the lawyer and the accountant who administered the decedent's estate. The court did not hold the draftsperson liable for malpractice because the will did not indicate any intent to minimize taxes upon the death of the surviving spouse. However, the court went on to find that the complaint stated a cause of action by the decedent's son against the lawyer

[8] *Id.*

[9] 663 So.2d 643 (Fla. Dist. Ct App. 1995)

and the accountant who were retained by the surviving spouse to probate the will and prepare the federal estate tax return because they failed to advise her of the possible tax savings that would have resulted if the surviving spouse disclaimed the general power of appointment and a QTIP marital deduction election was not made.

4. In Copenhaver v. Rogers,[10] the grandchildren, as remaindermen of the decedent, brought tort and contract claims against the draftsperson, contending that his failure to supply trust terms in the grandmother's will resulted in their losing the remainder interest in a residuary share intended for their mother. In addition, they complained that the lawyer failed, in the course of drafting wills for their grandparents, to advise their grandparents on the creation of a marital trust and provided incorrect tax advice about possible estate and generation-skipping tax consequences of proposed transfers resulting in additional monetary damages to them. The trial court held that the grandchildren had no claim against the lawyer for the negligent performance of legal services to the grandparents and they failed in their efforts to assert third party beneficiary contract claims against the lawyer. The Virginia Supreme Court affirmed. The court held that the grandchildren had no tort action against the lawyer in the absence of privity between them and the lawyer, and the grandchildren failed in the contract claim because they failed to allege and show that they were clearly intended as third party beneficiaries in the contract (the preparation of the wills) between the grandparents and the lawyer.

5. Virginia has continued to uphold the use of lack of privity as a defense. In Rutter v. Jones, Blechman, Woltz & Kelly,[11] the Virginia Supreme Court held that no intended beneficiary could sue the decedent's estate planning lawyer for alleged negligence when a testator's estate plan failed to achieve its intended purpose even when the action was brought by the personal representative of the decedent's estate, since the action for malpractice did not arise until after the client had died and the personal representative, who was limited under Virginia law in bringing only actions that arose before death, presented no viable claim for malpractice.

E. Metadata. On area of technology with which lawyers need to show competence is metadata.

[10] 384 Se. 2d 593 (Va. 1989)

[11] 568 S.E. 2d 693 (Va. 2002)

1. “Metadata," is essentially data about data. This involves the same basic issue as the inadvertent transmission of documents, but is even more tricky because the person sending the document might not even know that the "metadata" is being transmitted and can be read. Model Rule 4.4(b) reads:

   > (b) A lawyer who receives a document or electronically stored information relating to the representation of the lawyer’s client and knows or reasonably should know that the document or electronically stored information was inadvertently sent shall promptly notify the sender.

2. A chronological list of state ethics opinions dealing with metadata highlights the states' widely varying approaches. The following is a chronological list of state ethics opinions, and indication of whether receiving lawyers can examine an adversary's electronic document for metadata.

   2001

   New York LEO 749 (12/14/01) -- **NO**

   2004

   New York LEO 782 (12/18/04) -- **NO**

   2006

   ABA LEO 442 (8/5/06) -- **YES**

   Florida LEO 06-2 (9/5/06) -- NO

   2007

   Maryland LEO 2007-9 (2007) -- **YES**

   Alabama LEO 2007-02 (3/14/07) -- **NO**

   District of Columbia LEO 341 (9/2007) -- **NO**

   Arizona LEO 07-3 (11/2007) -- **NO**

   Pennsylvania LEO 2007-500 (2007) -- **YES**

   2008

   N.Y. County Law. Ass'n LEO 738 (3/24/08)-- **NO**

Colorado LEO 119 (5/17/08) -- **YES**

Maine LEO 196 (10/21/08) -- **NO**

2009

Pennsylvania LEO 2009-100 (2009) -- **YES**

New Hampshire LEO 2008-2009/4 (4/16/09) -- **NO**

West Virginia LEO 2009-01 (6/10/09) -- **NO**

Vermont LEO 2009-1 (10/2009) – **YES**

2010

North Carolina LEO 2009-1 (1/15/10) -- **NO**

Minnesota LEO 22 (3/26/10) -- **MAYBE**

2011

Oregon LEO 2011-187 (11/2011) -- **YES** (using "standard word processing features") and **NO** (using "special software" designed to thwart metadata scrubbing).

2012

Washington LEO 2216 (2012) -- **YES** (using "standard word processing features") and **NO** (using "special forensic software" designed to thwart metadata scrubbing).

2016

New Jersey Rules change (4/14/16) – **YES** (if receiving lawyers reasonably believe the metadata was not inadvertently sent).

Texas LEO 665 (12/16) **– YES**

3. Thus, states take widely varying approaches to the ethical propriety of mining an adversary's electronic documents for metadata.

   a. Interestingly, neighboring states have taken totally different positions. For instance, in late 2008, the Maine Bar prohibited such mining -- finding it "dishonest" and prejudicial to the administration of justice -- because it "strikes at the foundational principles that protect attorney-client confidences." Maine LEO 196 (10/21/08).

b. About six months later, New Hampshire took the same basic approach (relying on its version of Rule 4.4(b)), and even went further than Maine in condemning a receiving lawyer's mining of metadata -- analogizing it to a lawyer "peeking at opposing counsel's notes during a deposition or purposely eavesdropping on a conversation between counsel and client." New Hampshire LEO 2008-2009/4 (4/16/09).

c. However, Vermont reached exactly the opposite conclusion in 2009. Pointing to its version of Rule 4.4(b), Vermont even declined to use the term "mine" in determining the search, because of its "pejorative characterization." Vermont LEO 2009-1 (9/2009).

4. Basis for States' Differing Positions

a. In some situations, the bars' rulings obviously rest on the jurisdiction's ethics rules. For instance, the District of Columbia Bar pointed to its version of Rule 4.4(b), which the bar explained is "more expansive than the ABA version," because it prohibits the lawyer from examining an inadvertently transmitted writing if the lawyer "knows, before examining the writing, that it has been inadvertently sent."[12]

b. On the other hand, some of these bars' rulings seem to contradict their own ethics rules. For instance, Florida has adopted ABA Model Rule 4.4(b)'s approach to inadvertent transmissions (requiring only notice to the sending lawyer), but the Florida Bar nevertheless found unethical the receiving lawyer's "mining" of metadata. [13]

c. Other jurisdictions have not adopted any version of Rule 4.4(b), and therefore were free to judge the metadata issue without reference to a specific rule.[14]

[12] District of Columbia LEO 341 (9/2007).

[13] Florida LEO 06-2 (9/16/06).

[14] See, e.g., Alabama LEO 2007-02 (3/14/07).

d. On the other hand, some states examining the issue of metadata focus on the basic nature of the receiving lawyer's conduct in attempting to "mine" metadata. Such conclusions obviously do not rest on a particular state's ethics rules. Instead, the different bars' characterization of the "mining" reflects a fascinating dichotomy resting on each state's view of the conduct.

(1) On March 24, 2008, the New York County Bar explained that mining an adversary's electronic documents for metadata amounted to unethical conduct that "is deceitful and prejudicial to the administration of justice."[15]

(2) Less than two months later, the Colorado Bar explained that "there is nothing inherently deceitful or surreptitious about searching for metadata."[16]

(3) A little over five months after that, the Maine Bar explained that "[n]ot only is the attorney's conduct dishonest in purposefully seeking by this method to uncover confidential information of another party, that conduct strikes at the foundational principles that protect attorney-client confidences, and in doing so it clearly prejudices the administration of justice."[17]

Thus, in less than seven months, two states held that mining an adversary's electronic document for metadata was deceitful, and one state held that it was not.

III. PROVIDING EFFECTIVE AND TIMELY COUNSEL TO CLIENTS

A. Model Rule 1.3 relates to diligence and reads:

> A lawyer shall act with reasonable diligence and promptness in representing a client.

B. One area in which clients often become frustrated is the failure of a lawyer to handle estate planning or estate administration matters promptly. Even in situations in which a lawyer is trying to act as promptly as possible,

[15] N.Y. County Law. Ass'n LEO 738 (3/24/08).

[16] Colorado LEO 119 (5/17/08).

[17] Maine LEO 196 (10/21/08).

delays in completing work can arise. With the increased pressure to produce revenue, lawyers may take on more work than they can handle in a timely and effective manner. The possibility of this is recognized in Comment 2 to Model Rule 1.3, which states:

> A lawyer's work load must be controlled so that each matter can be handled competently.

C. The adverse consequences of failing to act with promptness in representing a client are expressed in Comment 3 to Model Rule 1.3, which reads:

> Perhaps no professional shortcoming is more widely resented than procrastination. A client's interest often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and undermine confidence in the lawyer's work…

D. In certain transactions involving multiple family members, the need to consult with and coordinate among the family members may require more time than the lawyer might expect. The lawyer needs to take this into account to be able to handle the particular transaction in a timely manner.

E. The results have varied in cases in which a lawyer's diligence has been questioned, but each case shows that timely counsel may have helped to avoid problems.

1. In Rodovich v. Locke-Paddon,[18] Rafael Rodovich, when he married Mary Ann Borina in 1957, entered into a prenuptial agreement which stated that each party's property would remain his or her separate property. In 1973, Borina executed a will, which after making specific gifts to Rodovich and others, gave the residue of the estate to two charitable remainder trusts. Rodovich was one of the private beneficiaries of the two charitable remainder trusts.

a. In 1991, the lawyer, Locke-Paddon, met with Borina to discuss drafting a new will. At that meeting, the lawyer learned that the decedent had been diagnosed with breast cancer and was receiving chemotherapy treatments. The

[18] 35 Cal.Rptr.2d 573 (Cal. App. Ct. 1995)

purpose of the meeting was to discuss the preparation of a new will under which Rodovich was to receive all of the payments from a charitable remainder trust with which Borina intended to fund with most of her estate.

b. The lawyer delivered a rough draft of the will more than three months after the meeting. His understanding was that the next move was Borina's since Borina had told the lawyer that she intended to confer with her sister before finalizing the provisions of the will. The lawyer never heard from the decedent prior to her death on December 19, 1991.

c. Rodovich sued the lawyer on the grounds that the lawyer owed a duty of due care and reasonable diligence to Rodovich as the proposed private beneficiary of the charitable remainder unitrust to make sure that the decedent's wishes would be effected with reasonable promptness and diligence. The trial court framed the issue as to whether the lawyer's duty to use professional skill, prudence, and diligence extended beyond Borina to Rodovich. The trial court concluded and the appellate court agreed that the duty did not extend to Rodovich.

d. However, despite the favorable result for the lawyer, one must wonder whether the lawyer's position would have been further strengthened if the lawyer had regularly communicated with Borina to see how the review of the draft will was proceeding.

2. In People v. James,[19] a client employed a lawyer, Joseph C. James, to prepare a will. The client was seventy-five years old and attempted to contact the lawyer on several occasions concerning its completion with no success. The will was executed eight months after the client requested the preparation of the will and only after the filing of a complaint with the Colorado Bar Grievance Committee. The Grievance Committee found that the lawyer's failure to prepare a will for at least eight months after the initial contact by the client, especially where the client was elderly, was "grossly negligent and shows a total lack of responsibility." Apparently, private censures had been administered to the lawyer on two other occasions and the lawyer was suspended for one year as a result of other derelictions of duty. In this case, the Colorado Supreme Court determined that disbarment was the appropriate

[19] 502 P.2d 1105 (Cal. 1972)

action. Most, if not all, readers of this case, should agree that the lawyer failed to act diligently in the representation.

3. In re Discipline of Helder.[20] In this case, the lawyer failed to communicate with a client for more than six months after a client repeatedly requested the lawyer to make changes in the client's will. Only after the client filed a complaint with the Lawyers Professional Responsibility Board, did the lawyer advise the client that the lawyer was not actively practicing law and return the client's file. As a result of this matter and an unrelated matter involving the defense of a contractual issue, the lawyer was indefinitely suspended from the practice of law.

4. Disciplinary Action Against MacGibbon. [21]

    a. In this case, a lawyer named MacGibbon first served as counsel for the personal representative and then as the successor personal representative of an intestate administration of an estate that required thirty years for administration.

    b. The decedent, Axel Anderson, died in 1964. At that time, Anderson owned approximately 280 acres of farm land with a value of $9,000 and bonds worth $5,000. From 1964 until 1980, according to MacGibbon, the estate's primary focus was on efforts to sell the real estate. One parcel was sold in 1972 and a second was sold in 1980. A third parcel had been listed for sale with a real estate broker since 1992.

    c. The originally appointed personal representative died in 1981. At that point MacGibbon became personal representative. He spent much of the 1980's attempting to locate the heirs.

    d. The court noted that neglect in probating estates had long been considered as serious professional misconduct. It determined that MacGibbon should be publicly reprimanded for his neglect and be removed as personal representative of the estate.

[20] 396 N.W.2d 559 (Minn. 1986)

[21] 535 N.W.2d 809 (Minn. 1995)

IV. COMMUNICATION

A. Representation of multiple members of a family also implicates Model Rule 1.4, which deals with communication with clients. Model Rule 1.4 reads:

> (a) A lawyer shall:
>
> > (1) promptly inform the client of any decisions or circumstances with respect to which the client's informed consent, as defined by Rule 1.0(e) is required by these Rules:
> >
> > (2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;
> >
> > (3) keep the client reasonably informed about the status of the matter;
> >
> > (4) promptly comply with reasonable requests for information; and
> >
> > (5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.
>
> (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

B. Considerations in the Official Commentary on Model Rule 1.4.

1. Regular communication. Comment four to Model Rule 1.4 states that regular communications with clients will minimize the occasions on which a client will need to request information concerning the representation. When a client makes a reasonable request for information, the lawyer must promptly comply with the request. If a prompt reply is not possible, the lawyer or member of the lawyer's staff should acknowledge receipt of the request and advise the client when a response may be expected. The basic rule is that a lawyer should promptly respond to or acknowledge client communications.

2. Explaining matters. Comment five to Model Rule 1.4 deals with explaining matters to a client. Pursuant to this, the client should

have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued. The guiding principle is that a lawyer should fulfill a client's expectations for information consistent with the duty to act in the client's best interest.

3. Withholding information. The lawyer is rarely justified in withholding information from the client. Comment seven indicates that a lawyer may be justified in delaying transmission of information when the client might react imprudently to an immediate communication. The example given in the commentary is that of withholding a psychiatric diagnosis of a client when the examining psychiatrist indicates that disclosure would harm the client. The commentary is clear that a lawyer may not withhold information to serve a lawyer's own interest or convenience or at the interest or convenience of another person.

C. The requirement of regular communication may cause tensions in a situation in which a lawyer is representing more than one member of a family in a transaction for estate planning or tax planning purposes. This would be especially true when one family member, who is a client, tells the lawyer not to mention or disclose certain information to other family members who are also clients with respect to the same transaction.

D. Case on Communication:

1. In Hotz v. Minyard[22], the lawyer Robert Dobson represented Mr. Minyard, his son, Tommy, daughter, Judy, and the family businesses, including multiple automobile dealerships. Tommy was in charge of his father's Greenville dealership, and Judy worked for her father at his Anderson dealership.

2. With Dobson's assistance, Mr. Minyard executed a will on October 24, 1984 that left Tommy the Greenville dealership, gave other family members $250,000, and left the residuary estate in trust to his wife for life, with the remainder equally to Tommy and to a trust for Judy. The will was executed with Mr. Minyard's wife, his secretary, and Tommy in attendance. Later that day, Mr. Minyard executed a second will containing the same provisions as the first except that it gave the Greenville dealership real estate to Tommy outright. Mr. Minyard told Dobson that the existence of the second will was to remain a secret and specifically directed Dobson not to tell Judy of its existence.

[22] 403 S.E.2d 634 (S.C. 1991).

3. Judy subsequently requested a copy of her father's will. Dobson showed Judy the first will and discussed it with her in detail. After this discussion, Judy believed that she would receive the Anderson dealership, and that she would share the estate equally with Tommy. Dobson never told Judy that the first will was revoked.

4. The father subsequently suffered from serious health problems and became mentally incompetent. Tommy and Judy agreed that Judy would attend to their father's care while Tommy managed both dealerships. During this time, Judy questioned some of the business decisions Tommy was making with respect to the Anderson dealership. When Judy tried to return to the Anderson dealership, Tommy refused to relinquish control and eventually fired her.

5. Shortly after Judy consulted with another lawyer about her concerns over Tommy's actions, Mr. Minyard executed a codicil, drafted by Dobson, removing Judy and her children as beneficiaries. Dobson subsequently convened a meeting with Judy, Tommy and her mother at his office. At that meeting, Judy was told if she dropped her plans for a lawsuit, she would be restored under her father's will and could work at the Greenville dealership. Believing that restoration under the will meant the will that Dobson disclosed to her, Judy dropped her planned lawsuit and moved to Greenville to work at the dealership. Eventually, Tommy fired Judy again.

6. Judy sued Dobson for breach of fiduciary duty based on his misrepresentation of her father's will. The Supreme Court of South Carolina held that Dobson owed Judy a duty with regard to her father's will because of their previous lawyer-client relationship, including preparing Judy's will and offering advice to Judy directly regarding issues at the dealerships. The court reasoned that even though the lawyer represented the father regarding his will, he owed Judy, as a client, the duty to deal with her in good faith and not actively misrepresent the first will or its status.

E. Extent of Continuing Duty to Client after Work is Completed.

1. Model Rule 1.4(a)(2) requires that a lawyer shall reasonably consult with the client about the means by which the client objectives are to be accomplished. One issue with respect to representation of family members in estate planning is whether after the initial planning is done or the estate planning work for which the lawyer is hired has been completed, the lawyer has an obligation to keep the client informed of changes in the law.

Clearly, if the representation continues, then there is likely a duty to keep the client informed of changes in the law. This can have consequences for the lawyer.

2. In Standish v. Stapleton an unreported decision out of the Connecticut Superior Court, the court found that a lawyer had no continuing duty to communicate with a former client where the lawyer represented various members of a family and was "drawn into what is in essence a family feud."[23]

   a. In Standish, lawyer Richard Stapleton drafted a trust agreement for Coral Moore, the mother of Gail Standish, Gary Moore and Wilbur Moore. Each of the children were beneficiaries of the Trust, and Stapleton was designated as a successor trustee. In her 1988 will, Coral bequeathed her one-half interest in a house to Gail, who owned the other one-half interest. In 1992, Stapleton represented both Coral and Gail in closing on an equity line of credit on Coral's one-half interest in the property. Coral subsequently executed a new will, drafted by Stapleton, in 1993. In the 1993 will, she still gifted her interest in the house to Gail, but the bequest was subject to any encumbrances on the property at the time of Coral's death, including any line of credit. Upon Coral's death in 1995, the interest in the house passing to Gail was subject to a $140,000 encumbrance.

   b. After the will was probated, Gail sued Stapleton, alleging, among other things, that Stapleton breached his fiduciary duty to Gail, both as Trustee of Coral's trust and as Gail's lawyer, in his representation of Gail relating to the line of credit. The court found that Stapleton did not have a duty to Gail to inform her either of Coral's 1993 will or of Coral's use of the equity line of credit. In reaching its decision, the court specifically considered Rule 1.4 of the Rules of Professional Conduct and found that because Gail had made no "request" for information, Stapleton's duty was limited to keeping Gail "reasonably informed" about the status of the "matter." Since the "matter" was the creation of the line of credit, there was nothing to inform Gail of after its creation.

[23] Case No. 394608, 2000 Conn. Super. LEXIS 2970 (Nov. 8, 2000).

3. In Lama Holding Company v. Sherman & Sterling,[24] the Sherman & Sterling law firm created a holding company to facilitate the purchase of certain stock to take advantage of favorable treatment under the tax law. Bankers Trust was retained as the exclusive agent for the purchase of the stock. Without consulting either defendant, the holding company sold the stock. The holding company claimed that the failure of the law firm and the investment bankers to inform them of changes in the tax law caused them to incur an unduly burdensome tax liability. The court denied Sherman & Sterling's motion to dismiss while granting Bankers Trust's motion to dismiss. The court found that the question of whether Sherman & Sterling promised to inform plaintiffs of significant changes in the tax laws and whether its failure to do so caused injury to the plaintiffs were questions of facts for a jury. Changes in the tax laws would affect the investment. As a result, the complaint stated sufficient facts for claims of malpractice, negligent misrepresentation, and breach of fiduciary duty. The court dismissed the claim against Bankers Trust because the holding company's claim that the investment bankers failed to alert plaintiffs as to changes in tax law was too amorphous since the holding company independently negotiated the sale of the stock without consulting Bankers Trust.

4. Standish v. Stapleton and Lama Holding Company illustrate the issue of what steps lawyers should take to terminate the representation and thus avoid any issue of a continuing representation.

   a. Model Rule 1.16 deals with declining or terminating a representation. The rules under Model Rule 1.16 deal primarily with litigation and corporate matters. Thus, Model Rule 1.16 deals more with the situation in which a lawyer believes that he or she can no longer represent a client.

   b. Under Model Rule 1.16(b)(1), a lawyer may withdraw from representing a client if the withdrawal can be accomplished without a material adverse effect on the interests of a client.

   c. The ACTEC Commentaries indicate that a lawyer may withdraw from representation if a client persists in criminal or fraudulent conduct; the lawyer discovers after the fact that his or her services have been used by client to perpetrate a fraud or crime; the client wishes to pursue

[24] 758 F. Supp. 159 (S.D.N.Y. 1991)

objectives that the lawyer finds to be repugnant or with which the lawyer has a fundamental disagreement; the client fails to pay the lawyer's bill after receiving sufficient notice from the lawyer of the need to do so; the representation will place an unreasonable financial burden on the lawyer or the client has made the representation unreasonably difficult; or there is other good cause such as a mutual antagonism between the lawyer and the client or a breakdown of the lawyer-client relationship.

5. Dormant Representation.

a. The rules and comments noted above offer little guidance with dormant representation. The ACTEC Commentaries on Model Rule 1.4 include a comment on dormant representation. The comment notes that the execution of estate planning documents and the completion of related matters, such as changes in beneficiary designations and the transfer of assets to the trustee of a trust, normally ends the period during which the estate planning lawyer actively represents an estate planning client. At that time, unless the representation is terminated by the lawyer, the representation becomes dormant awaiting activation by the client.

b. The ACTEC Commentaries go on to state that, although the lawyer remains bound to the client by some obligations, including the duty of confidentiality, the lawyer's responsibilities are diminished by completion of the active phase of the representation. The ACTEC Commentaries state that a lawyer may communicate periodically with the client regarding the desirability of reviewing his or her estate planning documents and send the client individual letters or form letters, pamphlets, or brochures regarding changes in the law that might affect the client. They then state that, in the absence of an agreement to the contrary, the lawyer is not obligated to send a reminder to the client whose representation is dormant or to advise the client of the impact that changes in the law or that client's circumstances might have.

c. While the position in the ACTEC Commentaries may be correct, clients may believe that the lawyer does continue to have a duty to inform them when there is a change in the law or there are circumstances that arise which might affect their estate plans. To avoid any misunderstanding, the best practice is for lawyers to specifically terminate the relationship upon the completion of the actions to which they are engaged.

d. This can be especially important in a situation involving several family members who might believe that one lawyer is representing all of them with respect to a technique such as the creation or funding of a family limited partnership or the funding of a grantor retained annuity trust or a sale to defective grantor trust transactions.

e. Of course, if the lawyer continues to represent the partnership or continues to provide advice with respect to the grantor retained annuity trust or on the administration of the defective grantor trust, or another technique for example, the relationship will not be terminated and the lawyer does have a duty to inform the clients of changes in tax laws that might affect those techniques.

f. The basic choice is whether the lawyer wants to have a continuing obligation to keep clients informed of changes that might affect their estate planning or not. While this can be beneficial from a client relationship standpoint and continuing to receive work from the client, it does place a burden on the lawyer and the lawyer should consider that carefully.

g. One solution, of course, is to terminate the relationship, but continue to be in contact with the now former clients when there are changes in the tax law and to suggest to the former clients that there are changes in the tax law and that they might wish to re-engage the law firm to look at the possible impact of these changes upon the clients' estate plans. This practice will help insulate lawyers from possible liability.

V. CONFIDENTIALITY OF INFORMATION

A. Model Rule 1.6 (a) reads:

> A lawyer shall not reveal information relating to representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

B. Under Model Rule 1.6 (b) a lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

1. to prevent reasonably certain death or substantial bodily harm;

2. to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.

3. to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services.

4. to secure legal advice about the lawyer's compliance with these Rules:

5. to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against he lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

6. to comply with other law or a court order.

C. The ACTEC Commentary to Model Rule 1.6 includes significant discussion of the impact Rule 1.6 has on lawyers representing multiple family members. The Commentary notes that "[w]hen the lawyer is first consulted by multiple potential clients, the lawyer should review with them the terms upon which the lawyer will undertake the representation, including the extent to which information will be shared among them."

D. Issues arise when a lawyer receives information from one joint client that the disclosing client does not want shared with another joint client. In the event that the information received is both relevant and significant, the lawyer may urge the disclosing client to share the information directly with the other clients. If the communicating client refuses to do so, the lawyer faces a difficult situation for which there is often no clear course of action. The ACTEC Commentary advises that the lawyer consider "his or her duties of impartiality and loyalty to the clients; any express or implied agreement among the lawyer and the joint clients that information communicated by either client to the lawyer or otherwise obtained by the lawyer regarding the subject of the representation would be shared with the other client; the reasonable expectations of the clients; and the nature of the confidence and the harm that may result if the confidence is, or is not, disclosed."

E. Case on Confidentiality.

1. The Supreme Court of New Jersey held that a law firm jointly representing a husband and wife in estate planning matters was entitled to disclose to the wife the existence of the husband's child born out of wedlock in A v. B v. Hill Wallack.[25] In that case, the law firm learned of the child not from the husband but from the child's mother, who had retained the law firm to pursue a paternity action against the husband. Because of a clerical error, the firm's conflict of interest check did not reveal the conflict.

2. The Hill Wallack court reasoned that the husband's deliberate failure to disclose the existence of the child when discussing his estate plan with the law firm constituted a fraud on the wife which the firm was permitted to rectify under Model Rule 1.6. The court also based its decision on the existence of an engagement letter waiving any potential conflicts of interest, suggesting that the letter reflected the couple's implied intent to share all material information with each other in the course of their estate planning.

3. Lessons from Hill Wallack.

   a. Hill Wallack demonstrates the importance of setting forth the grounds of the representation in the engagement letter, including the extent to which information will be shared.

   b. The case also highlights the importance of conducting thorough conflicts checks when taking on new clients or new matters for existing clients.

VI. CONFLICTS OF INTEREST

A. Introduction. Often lawyers are requested to represent two or more family members in a particular transaction, even though the interests of the family members may differ. There are two views on multiple representation in the estate planning and tax areas.

1. One view is that common representation should be avoided. In the event of a genuine dispute, a lawyer's liability for representing clients with conflicting interests is likely to arise.[26]

2. The other view is that multiple representation is often appropriate. Among the reasons given are the following:

[25] 726 A.2d 924 (N.J. 1999).

[26] Patricia A. Wilson. Avoiding Ethical Pitfalls for Estate Planning Lawyers. 331 PLI/EST 589 (Nov. 2004).

a. Cost savings;

b. The impracticality of requiring independent representation of all who have potentially conflicting interests; and

c. The possibility of losing one or more clients, unless the representation is actually impermissible, could have negative economic consequences for the lawyer.[27]

B. Ethical Rules.

1. Model Rule 1.7(a), which governs whether a lawyer may represent multiple parties, reads as follows:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client; or
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person or by a personal interest of the lawyer.

2. While Model Rule 1.7(a) creates the presumption that the lawyer cannot provide common representation, this presumption can be overcome. Model Rule 1.7(b) permits a lawyer to represent multiple clients, despite the existence of a conflict of interest, in certain situations. Model Rule 1.7(b) reads:

> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) The representation is not prohibited by law;

[27] Wilson, supra, at p. 593.

(3) The representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) Each affected client gives informed consent, confirmed in writing.

3. Thus, in representing a husband or wife or multiple generations in a tax or estate planning transaction, a lawyer needs to determine the following:

a. Whether there is a concurrent conflict of interest.

b. If there is a concurrent conflict of interest, whether his or her representation of one or more clients will be materially limited by the lawyer's responsibilities to another client.

c. If there is a concurrent conflict of interest and the representation of each client will not be materially limited, and the lawyer believes that he or she will be able to provide competent or diligent representation to each affected client and each affected client gives informed written consent.

4. Among the factors to be used in determining whether representation of one client forecloses the lawyer's ability to recommend or carry out appropriate courses of actions on behalf of another client are:

a. The lawyer's relationship with the clients involved.

b. The functions the lawyer will perform.

c. The likelihood of consent.

d. The prejudice that will occur if a conflict arises.[28]

5. To obtain informed written consent, the lawyer must describe the risks of multiple representation and the possible effects of representation, including the possible effect on the lawyer's independent judgment.

[28] Model Rules of Professional Conduct, Rule 1.7, comment 11.

6. The lawyer should also consider whether information disclosed by one client might have to be disclosed in order to obtain consent or as part of the representation. The client whose confidences are to be disclosed will have to give consent to this disclosure.[29]

C. Advice in ACTEC Commentaries. The ACTEC Commentary on Model Rule 1.7 gives the following advice.

1. ACTEC believes that it is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate planning or more than one of the investors in a closely held business. The reasons for this include:

a. The clients may actually be better served by such a representation.

b. Such a representation can result in an economical and better coordinated plan because the lawyer will have a better overall understanding of all the relevant family and property considerations.

c. In addition, estate and tax planning is, according to ACTEC, fundamentally nonadversarial in nature.

d. With respect to obtaining consent, ACTEC suggests that the lawyer consider meeting with the prospective clients separately. This may allow each of them to be more candid and perhaps reveal conflict or problems that might affect the relationship.

2. Thus, ACTEC appears to favor multiple representations as much as possible.

D. Representing Husband and Wife.

1. The most common multiple representation situation encountered by estate planners and tax professionals is representing a husband and wife. Much has been written on this topic and the consensus seems to be that the best way to handle the potential conflicts inherent in representing spouses is to anticipate them by making clear to both spouses at the beginning of the representation that, as between the spouses, the lawyer will not preserve confidences revealed in the course of the representation.

[29] Wilson, supra, at p. 595.

a. Some lawyers do represent husbands and wives as separate clients. If a lawyer is going to represent a husband and a wife as separate clients and information communicated by one spouse will not be shared with the other spouse, then each spouse must give informed consent under Model Rule 1.7(b)(4).

b. Such separate representation raises the same issues as those discussed below that arise with the representation of different generations of family members in the same estate planning matter.

2. A good summary of the issues involving the representation of spouses is found in Jeff Pennell's case book.[30] Some of the factors that may cause the interests of spouses to be different include:

a. Separate assets;

b. Children from a different marriage or relationship;

c. The risk of creditors of one spouse acquiring access to the assets of the other spouse; and

d. The potential use of gift splitting.

3. The ACTEC Commentary to Model Rule 1.7 also discusses the representation of a husband and wife. It indicates that the representation should only be taken with the informed consent of each of husband and wife confirmed in writing. The Commentary suggests the writing be contained in an engagement letter that covers other subjects as well.

4. A 1994 report by an American Bar Association Real Property, Probate and Trust Section Task Force[31] also discussed the signs of potential conflict arising between multiple clients such as a husband and wife and which, in turn, could imperil a joint representation. These signs include:

[30] Jeffrey Pennell. Wealth Transfer Planning and Drafting (Thomson West 2005), ch. 3, p. 6.

[31] Report of the Special Study Committee on Professional Responsibility. Comments and Recommendations on the Lawyer's Duties in Representing Husband and Wife.

a. Action related confidences that ask the lawyer to reduce or defeat the other spouse's rights or interests in the confiding spouse's property.

b. Prejudicial confidences that reveal adversity between the spouses (such as a plan to file for divorce following receipt of a transfer of property from the unknowing donor spouse).

c. Confidences indicating that one spouse's reliance on the plan of the other is misplaced.

5. Every joint representation carries the risk that one or more clients might feel betrayed or that the lawyer might be compelled to withdraw from representing all of the clients. These risks can be reduced by the lawyer properly creating and defining the joint representation.

a. The first issue to deal with is the issue of loyalty. As noted above, Model Rule 1.7 requires disclosure and written client consent only in the case of a "concurrent conflict of interest," which is a situation involving a direct adversity or a "significant risk" that a lawyer's representation of one client will be "materially limited" by the lawyer's responsibility to another client. This means that the Model Rules do not require full disclosure and consent until the conflict is nearly upon the lawyer.

b. Restatement (Third) of the Law Governing Lawyers, Sec. 130 Illustration 1, provides a good example of this dilemma:

> Husband and Wife consult Lawyer for estate-planning advice about a will for each of them. Lawyer has had professional dealings with the spouses, both separately and together, on several prior occasions. Lawyer knows them to be knowledgeable about their respective rights and interest, competent to make independent decisions if called for, and in accord with their common and individual objectives. Lawyer may represent both clients in the matter without obtaining consent. While each spouse theoretically could make a distribution different from the others, including a less generous bequest to each other, those possibilities do not create a conflict of interest, and

> none reasonably appears to exist in the circumstances.

c. Restatement (Third) of the Law Governing Lawyers, Sec. 130, Illustration 2, shows when the conflict would arise.

> The same facts as in Illustration 1, except that Lawyer has not previously met the spouses. Spouse A does most of the talking in the initial discussions with Lawyer. Spouse B, who owns significantly more property than Spouse A, appears to disagree with the important positions of Spouse A but to be uncomfortable in expressing that disagreement and does not pursue them when Spouse A appears impatient and peremptory. Representation of both spouses would involve a conflict of interest and Lawyer may provide legal assistance only with the consent of both.

d. Restatement (Third) of the Law Governing Lawyers, Sec. 130, Illustration 3, shows the steps that a lawyer could take to determine whether the situation in Illustration 2 actually presents a conflict.

> The same facts as in Illustration 1, except that Lawyer has previously met the spouses. But in this instance, unlike in Illustration 2, in discussions with the spouses, Lawyer asks questions and suggests options that reveal both Spouse A and Spouse B to be knowledgeable about their respective rights and interests, competent to make independent decisions if called for, and in accord on their common and individual objectives. Lawyer has adequately verified the absence of a conflict of interest and thus may represent both clients in the matter without obtaining consent.

e. Even if consent is not required, as the above illustrations indicate may be the case in representing a husband and wife, the better practice is to obtain consent and describe the scope of the joint representation.

6. Summary of Rules on Representing Husband and Wife.

a. The default position under the Model Rules is that there can be no secrets among jointly represented clients. Instead, the lawyer must tell all clients any material fact that the lawyer learns with respect to any client.[32]

b. The other approach is for the clients to agree on separate representations in the same matter. The problem with this, obviously, is that the lawyer must exercise extreme vigilance and the lawyer may find himself or herself paralyzed by knowledge that the lawyer learns from one client, but is unable to share with others. The ACTEC Commentaries to Model Rule 1.6, using some understatement, indicate that "some experienced estate planners" might enter into such a relationship with spouses planning their estate, but must proceed with "great care."

c. A middle ground in establishing the representation might be for the lawyer to state that the lawyer will share all material information about the representation from any client, but will withdraw from the entire representation if any client balks at such sharing. [33] This, of course, puts the burden on the lawyer of determining what is and is not material information.

E. Intergenerational Representation.[34] Just as in spousal representation, conflicts of interest in a family representation are swirling just below the surface and can snag the unwary lawyer at any time. Estate planning and tax lawyers are frequently involved in two other types of multiple representations that do not receive as much attention: Family or intergenerational representation; and representation of a partnership and individual partners.

1. One common scenario in which such conflicts arise involves a lawyer with a long term relationship with a client. As the client becomes successful, the lawyer prepares estate planning documents first for the parents and then for other family members. All seems peaceful until the original client dies and the survivors squabble over the division of assets. Eventually, some of the

[32] Model Rule 1.7, comments 30 and 31.

[33] For further discussion of this, see Thomas Spahn, "Creating and Defining Joint Representations", ABA Experience, Spring 2007, p. 45.

[34] This portion of the outline is based, in part, upon materials prepared by Schiff Hardin LLP lawyers, including Charles D. Fox IV, during his tenure at that firm and are used with its permission.

survivors may turn on the family lawyer for failing to represent their individual interests.

2. For example, in a case described by the malpractice carrier for the lawyer involved, a lawyer was sued 20 years after probating the will of a longtime client. The client had acquired substantial interests in real estate and oil prior to his final marriage. Under his estate plan, one-half of his community property was left to his wife, while the other half and all separate property was left to his descendants by a prior marriage. The client's grandchildren claimed that the lawyer had mischaracterized some assets as community property rather than separate property and that the widow had conspired with the lawyer in doing so. The widow filed a third-party complaint against the lawyer alleging negligence in the drafting of the estate plan and administration of the property. The case was settled for $14 million.[35]

F. Case Law on Conflict of Interest. Long before Charles and David Koch were making headlines for their funding of conservative policy and advocacy groups, they were involved in a will contest with two of their brothers, William and Frederick, over the will of their mother, Mary. In In re Estate of Koch, William and Frederick alleged that their mother's will was void as a product of undue influence and constructive fraud because of the drafting lawyer's conflict of interest.[36]

1. During the 1980s, numerous lawsuits were filed among members of the Koch family. The Wichita law firm of Foulston & Siefkin represented Koch Industries, Charles, David, Mary and the Fred C. Koch Foundation. In 1989, Mary called Robert Howard, a lawyer with the Foulston firm who was representing her in some of the family litigation and asked him to revise her will. Howard drafted and Mary executed a new will in 1989 which contained a no-contest clause and a provision that conditioned the gifts to each of her four sons on the dismissal by a beneficiary of any litigation that was pending against her within 60 days following her death.

2. After Mary's death, the will was offered for probate and the unrelated litigation previously initiated by Frederick and William had still not been dismissed. Under the terms of the will, Frederick and William would not receive gifts because of the pending litigation, resulting in the bulk of the estate passing to Charles and

[35] Attorneys' Liability Assurance Society, "Trusts and Estates Practice: Lawyers' Liability Issues," 1994, at 18-19.

[36] 849 P.2d 977 (Kan. Ct. App. 1993).

David. Frederick and William challenged the will, alleging among other things that the lawyer was acting on behalf of Charles and David when he prepared Mary's will, but the trial court rejected their challenges.

3. William and Frederick contended that Howard had a conflict of interest in violation of Model Rule 1.7 arising from his representation of Charles and David in intra-family litigation at the same time he undertook to represent Mary in revising her will. The trial court specifically found that Howard did not violate Model Rule 1.7 after considering expert testimony from leading lawyers on the topic of conflicts of interest. The appellate court upheld the trial court's finding and held:

> The scrivener's representation of clients who may become beneficiaries of a will does not by itself result in a conflict of interest in the preparation of the will. Legal services must be available to the public in an economical, practical way, and looking for conflicts where none exist is not of benefit to the public or the bar.

G. Loyalty Issues.

1. Lawyers can (1) separately represent clients on separate matters (which most lawyers generally do on a daily basis); (2) separately represent clients on the same matter; or (3) jointly represent clients on the same matter. Lawyers jointly representing clients on the same matter must be especially careful when undertaking and continuing such a joint representation.

2. The ABA Model Rules identify two issues that lawyers must address when jointly representing clients on the same matter.

   a. First, lawyers must deal with the issue of loyalty. The loyalty issue itself involves two types of conflicts of interest -- one of which looks at whether the lawyer's representation is directly adverse to another client, and the other of which requires a far more subtle analysis -- because it examines the representation's effect on the lawyer's judgment.

   b. Every lawyer is familiar with the first type of conflict of interest -- which exists if "the representation of one client will be directly adverse to another client." Model Rule 1.7(a)(1). At the extreme, this type of direct conflict involves a representation that the Model Rules flatly prohibit. Lawyers can never undertake a representation that involves "the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal." Model Rule 1.7(b)(3). Even if representation does not violate this flat prohibition, adversity might nevertheless create a conflict of interest if a lawyer represents one client "directly adverse" to another client. For instance, a lawyer jointly representing two co-defendants in a lawsuit obviously cannot "point the finger" against one of the clients (without consent), even if such an argument does not amount to "the assertion of a claim." Some describe this first variety of conflict as a "light switch" conflict, because a representation either meets this standard or it does not. This is not to say that it can be easy to analyze such conflicts. But a lawyer concluding that a representation will be "directly adverse to another client" must deal with the conflict.

c. The second type of conflict involves a much more subtle analysis. As the Model Rules explain it, this type of conflict exists if

> there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
>
> Model Rule 1.7(a)(2) (emphasis added).

(1) This has been called a "rheostat" conflict. Unlike making a "yes" or "no" determination as required in analyzing the first type of conflict, a lawyer dealing with a "rheostat" conflict has a more difficult task. The lawyer must determine if some other duty, loyalty or interest has a "significant risk" of "materially" limiting the lawyer's representation of a client. This often involves a matter of degree rather than kind. For example, a lawyer with mixed feelings about abortion might feel awkward representing an abortion clinic, but would be able to adequately represent such a client. However, a vehemently pro-life lawyer might well find her representation of such a client "materially limited" by her personal beliefs. Thus, this second type of conflict requires a far more subtle analysis than a

"light switch" type of conflict arising from direct adversity to another client.

(2) As with the first of type of conflict, a lawyer dealing with a "rheostat" conflict may represent a client only if the lawyer "reasonably believes" that she can "provide competent and diligent representation," the representation does not violate the law, and each client provide "informed consent." Model Rule 1.7(b).[37]

3. Second, lawyers must deal with the issue of information flow. Even if there is no conflict between jointly represented clients, lawyers must analyze whether they must, may or cannot share information learned from one jointly represented client with the other clients.

a. A comment to the Model Rules explains the factors that lawyers must consider when determining whether they can undertake a joint representation.

> In considering whether to represent multiple clients in the same matter, a lawyer should be mindful that if the common representation fails because the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails. In some situations, the risk of failure is so great that multiple representation is plainly impossible. For example, a lawyer cannot undertake common representation of clients where contentious litigation or negotiations between them are imminent or contemplated. Moreover, because the lawyer is required to be impartial between commonly represented clients, representation of multiple clients is improper when it is unlikely that impartiality can be maintained. Generally, if the relationship between the parties has already assumed antagonism, the possibility that the clients' interests can be adequately served by common representation is not very good. Other relevant factors are whether the lawyer

[37] The ABA Model Rules require such consent to be "confirmed in writing," but many states do not. ABA Model Rule 1.7(b)(4).

> subsequently will represent both parties on a continuing basis and whether the situation involves creating or terminating a relationship between the parties.[38]
>
> Thus, lawyers should consider whether adversity already exists, and the likelihood that it will arise in the future.

b. Lawyers concluding that they can enter into a joint representation (because adversity is not inevitable) have three basic options.

(1) First, they can say nothing to their clients -- and deal with any adversity if it develops. Because there is no conflict until such adversity develops, there is no need for disclosure and consent. The advantage of this approach is that the lawyer is more likely to obtain the business. The disadvantage is that all of the clients will be disappointed if adversity develops -- and might feel that the lawyer has been deceitful by not advising them of that possibility.

(2) Second, the lawyer can salute the possibility of adversity, and advise the clients that they (and the lawyer) will have to deal with adversity if it ever develops. This has the advantage of warning the clients that they might have to address adversity, but of course leaves the outcome of any adversity uncertain.

(3) Third, a lawyer can very carefully describe in advance what will happen if adversity develops. In most situations, the lawyer will have to drop all of the clients. Model Rule 1.7 cmt. [29] ("Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails."). In certain limited situations, the clients might agree in advance that the lawyer will continue representing one of the clients and drop the other clients -- although there is rarely absolute certainty about that strategy working. The advantage of this approach is that the clients and the

[38] Model Rule 1.7 comment 29.

lawyer will know in advance what is likely to happen if adversity develops. The disadvantage of this approach is that the lawyer must describe this "parade of horribles" to the clients in advance -- and therefore may frighten away the potential clients.

4. ACTEC Commentaries.

a. Given the frequent joint representation of spouses or other family members in trust and estate planning work, it should come as no surprise that the ACTEC Commentaries extensively deal with a lawyer's responsibility for analyzing the propriety of such a joint representation.

b. Like the ABA Model Rules and the Restatement, the ACTEC Commentaries warn lawyers that they must assess the likelihood of adversity before undertaking a joint representation.

> A lawyer who is asked to represent multiple clients regarding related matters must consider at the outset whether the representation involves or may involve impermissible conflicts, including ones that affect the interests of third parties or the lawyer's own interests.[39]

c. For obvious reasons, a lawyer may not undertake a joint representation if serious adversity exists from the beginning.

> Some conflicts of interest are so serious that the informed consent of the parties is insufficient to allow the lawyer to undertake or continue the representation (a "non-waivable" conflict). Thus, a lawyer may not represent clients whose interests actually conflict to such a degree that the lawyer cannot adequately represent their individual interests. A lawyer may never represent opposing parties in the same litigation. A lawyer is almost always precluded from representing both parties to a pre-nuptial agreement or other matter with respect to which their interests directly conflict to a

[39] American College of Trust & Estate Counsel, Commentaries on the Model Rules of Professional Conduct, Commentary on MRPC 1.7.

> substantial degree. Thus, a lawyer who represents the personal representative of a decedent's estate (or the trustee of a trust) should not also represent a creditor in connection with a claim against the estate (or trust). This prohibition applies whether the creditor is the fiduciary individually or another party. On the other hand, if the actual or potential conflicts between competent, independent parties are not substantial, their common interests predominate, and it otherwise appears appropriate to do so, the lawyer and the parties may agree that the lawyer will represent them jointly subject to MRPC 1.7 or act as an intermediary pursuant to former MRPC 2.2 (Intermediary).

d. The presence of some adversity does not automatically preclude a lawyer from at least beginning a joint representation.

> Subject to the requirements of MRPCs 1.6 and 1.7 (Conflict of Interest: Current Clients), a lawyer may represent more than one client with related, but not necessarily identical, interests (e.g., several members of the same family, more than one investor in a business enterprise). The fact that the goals of the clients are not entirely consistent does not necessarily constitute a conflict of interest that precludes the same lawyer from representing them. See ACTEC Commentary on MRPC 1.7 (Conflict of Interest: Current Clients). Thus, the same lawyer may represent a husband and wife, or parent and child, whose dispositive plans are not entirely the same.[40]

e. Not surprisingly, lawyers must monitor possible later adversity.

> The lawyer must also bear this concern [possible "impermissible conflicts"] in mind as the representation progresses: What was a tolerable conflict at the outset may develop into one that

[40] American College of Trust & Estate Counsel, Commentaries on the Model Rules of Professional Conduct, Commentary on MRPC 1.6.

> precludes the lawyer from continuing to represent one or more of the clients.[41]

f. Thus, the ACTEC Commentaries recognize both a spectrum of adversity, and the possibility that the adversity might increase or decrease over time.

H. Lawyers Serving on Boards of Directors of Clients.

1. Although the frequency of lawyers serving on client boards of directors seems to be declining, lawyers continue to serve on their clients' boards of directors.

2. Comment 35, Model Rule 1.7 provides specific guidance on this issue.

> A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

3. In 1998, the ABA issued a legal ethics opinion providing more detail. In ABA LEO 410 (2/27/98), the ABA indicated that lawyers serving on a corporation's board of directors should warn the corporation that their discussions with the board might not be

[41] American College of Trust & Estate Counsel, Commentaries on the Model Rules of Professional Conduct, Commentary on MRPC 1.7.

protected by the attorney-client privilege (because they involve business advice rather than legal advice). The lawyer should also warn the other directors about the dangers of waiving the attorney-client privilege. The ABA also indicated that lawyers serving on their client's boards should consider declining to represent the clients in lawsuits involving actions that they opposed as directors. If the board might require an "advice of counsel" defense, the lawyer-director might suggest that the company should hire another lawyer to give that advice.

4. Although the ABA did not completely prohibit outside lawyer-directors from voting on any actions involving retaining, paying or discharging the lawyer-director's law firm,[42] the ABA suggested that outside lawyer-directors consider abstaining from such decisions.

5. The Restatement takes the same basic approach.

> A lawyer's duties as counsel can conflict with the lawyer's duties arising from the lawyer's service as a director or officer of a corporate client. Simultaneous service as corporate lawyer and corporate director or officer is not forbidden by this Section. The requirement that a lawyer for an organization serve the interests of the entity . . . is generally consistent with the duties of a director or officer. However, when the obligations or personal interests as director are materially adverse to those of the lawyer as corporate counsel, the lawyer may not continue to serve as corporate counsel without the informed consent of the corporate client. The lawyer may not participate as director or officer in the decision to grant consent.[43]

6. Lawyers serving on a client's board of directors should keep a number of special considerations in mind.

   a. First, they must determine whether they are acting in a director's or a lawyer's role each time they act -- which will frequently govern the availability of the attorney-client privilege. Perhaps more importantly, the lawyer must advise fellow board members that conversations with the lawyer's director might not be privileged (lay directors

[42] New York LEO 589 (3/18/88) (imposing a flat prohibition on such activity).

[43] Restatement (Third) of Law Governing Lawyers § 135 cmt. d (2000).

naturally would assume that any conversations with a lawyer-director would deserve privilege protection).

b. Second, lawyers serving as directors must remember that they are not acting as advocates for management, but rather as fiduciaries for all of the shareholders.

c. Third, directors who are lawyers at outside law firms which represent the company must avoid favoring the law firm at the expense of the company or its shareholders. To be even more careful, the lawyer should not serve as the law firm's main liaison with the client.

d. Fourth, lawyers should not assume that all possible conflicts problems can be cured by the lawyers recusing themselves in voting as directors on matters involving the lawyer or the lawyer's firm. This is because directors have a fiduciary duty to their shareholders, and at some point violate that fiduciary duty if they must avoid participating in important corporate decisions.

I. Lawyers Representing or Taking Positions Adverse to Corporations on Whose Board the Lawyer or the Lawyer’s Partner Sits.

1. Lawyers serving on a corporate board of directors must remember that their fiduciary duty to the corporation might conflict with their representation of the corporation or another client in a legal capacity.

2. Under Model Rule 1.7(a)(2):

> [e]xcept as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if . . . there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

3. ABA Model Rule 1.7(a)(2). A comment specifically mentions a lawyer's capacity as a board member.

> In addition to conflicts with other current clients, a lawyer's duties of loyalty and independence may be materially limited by responsibilities to former clients under Rule 1.9 or by the lawyer's responsibilities to other persons, such as fiduciary duties arising from a

> lawyer's service as a trustee, executor or corporate director.

4. The ABA Model Rules implicitly acknowledge that a lawyer or the lawyer's firm can represent a corporation on whose board the lawyer serves -- although warning that conflicts of interest "might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter."[44]

   a. The ABA also explained in a 1998 legal ethics opinion that the lawyer might have to decline a representation of the company in a matter involving actions that the lawyer/board member opposed as a director.[45]

   b. Not surprisingly, states also permit lawyers to represent corporations on whose board they serve.

5. Adversity to the corporation by the lawyer's firm (or obviously the lawyer herself) clearly implicates possible conflicts with the lawyer/board member's fiduciary duties to the corporation.

   a. The ABA Model Rules do not explicitly deal with this issue, but the Restatement indicates that such adversity requires consents -- presumably by the corporation and the corporation's adversary.

      > A second type of conflict that can be occasioned by a lawyer's service as director or officer of an organization occurs when a client asks the lawyer for representation in a matter adverse to the organization. Because of the lawyer's duties to the organization, a conflict of interest is present, requiring the consent of the clients under the limitations and conditions provided [elsewhere in the Restatement].[46]

   b. The Restatement also provides an illustration.

      > Lawyer has been asked to file a medical-malpractice action against Doctor and Hospital on behalf of Client. Hospital is operated by University, on whose Board of Trustees Lawyer serves. While Lawyer would not personally be liable for the

[44] ABA Model Rule 1.7 cmt. [35].

[45] ABA LEO 410 (2/27/98).

[46] Restatement (Third) of Law Governing Lawyers § 135 cmt. d (2000).

> judgment if Client prevails . . . , the close relationship between Lawyer and University requires that Lawyer not undertake the representation unless Client's consent is obtained pursuant to [other Restatement provision].[47]

c. State bars disagree about this issue. Several states have prohibited law firms from representing clients suing corporations on whose board a firm lawyer serves -- finding an irreconcilable conflict that cannot be cured with consent.

(1) Ohio LEO 2008-2 (6/6/08) (holding that a law firm cannot represent a client adverse to a corporation on whose board one of the law firm's lawyers sits; explaining the ethics issues implicated by a lawyer serving on a corporate board; "Serving in a dual role as a corporate director and corporate counsel is cautioned because of the ethical challenges: conflicts of interest calling into question the lawyer's professional independence; confusion among other directors and management as to whether a lawyer's views are legal advice or business suggestions; and concerns regarding protection of the confidentiality of client information, especially the attorney-client privilege. See ABA Formal Opinion 98-410 (1998). A common example of a conflict of interest calling into question a lawyer's independent judgment would be if a lawyer director is called upon to advise the corporation in matters involving the actions of the directors."; holding that the lawyer sitting on the board could not personally represent a client adverse to the corporation; "The lawyer's duties as a corporate director would materially limit the lawyer's ability to represent the client against the corporation."; "The corporation is not technically a client of a lawyer director who is not corporate counsel, but a lawyer director cannot isolate the fiduciary duties owed to the corporation from his professional duties as a lawyer."; disagreeing with other authorities, and imputing the individual lawyer's disqualification to the entire law firm; "The material limitation conflict of interest of a lawyer who serves as a corporate director and

[47] Restatement (Third) of Law Governing Lawyers § 135 cmt. d, illus. 4 (2000).

whose client is suing the corporation arises from both the lawyer's fiduciary duties to the corporation and the lawyer's personal interest in serving on the board. Both of these material limitation conflicts of interest, the personal interest and the fiduciary duties owed, pose a significant risk of materially limiting the lawyer's loyalty and independence in representing a client against the corporation."; "Thus, the Board's view is that the conflict of interest of the lawyer who serves as corporate director and not as corporate counsel and whose client is suing the corporation is imputed to other lawyers in the firm under Rule 1.10(a). Because the prohibited lawyer's conflict is based upon a fiduciary duty to the corporation as well as a personal interest of the prohibited lawyer and presents a significant risk of materially limiting the representation of the client[,] the conflict is imputed to the law firm pursuant to Rule 1.10(a)."; finding that the law firm may not represent the other client adverse to the corporation even if the corporation consents; "Rule 1.10(e) does provide for waiver of the law firm's disqualification upon consent of the affected client under conditions stated in Rule 1.7. But, pursuant to Rule 1.7(c)(2), the conditions for waiving a conflict under Rule 1.7(b) cannot be met, because the corporation and the client are directly adverse to each other in the same proceeding. The corporation is not a client of the law firm but a lawyer director's fiduciary duties to the corporation cannot be isolated from the lawyer's professional duties.").

(2) North Carolina RPC 160 (7/21/94) (holding that a lawyer cannot file a lawsuit against a board on which one of the law firm's associates sits; "Under Rule 5.1(b) [now Rule 1.7], an irreconcilable conflict would exist if a lawyer who is a member of the board of trustees of a nonprofit hospital were to represent a client who is suing the board or the hospital which is managed and controlled by that board. Rule 5.1(b). While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by the Rules of Professional Conduct. Rule 5.11(a) and CPR 66.").

d. At least one state took a more liberal approach -- permitting such adversity if the adverse party consented (thus apparently not requiring the corporation's consent as well).

> In Virginia LEO 1821 (1/11/06) (explaining that a lawyer may file a lawsuit against a trust company on whose board the lawyer's partner sits (but who does not represent the trust department) if (1) the "affected client" (the plaintiff suing the trust company) consents; and (2) the lawyer "reasonably believes" that he can "provide competent and diligent representation" to his clients; noting that although the board member's recusal is not mentioned as a cure in the rules, it is a factor in analyzing the second requirement, which could be met if the board (in consultation with its lawyer) allows such recusal, after considering "such matters as whether the litigation is 'routine' or 'non-routine' in the course of the board's business; whether the claim goes to matters that had been determined by the board, or lower level administrative staff; and whether the claim involves matters on which [the partner who is a member of the board] has voted or has been involved in."; acknowledging that the board member's resignation might cure the conflict, unless there is some contractual undertaking that would affect his post-withdrawal activities; warning that under Rule 4.2, the plaintiff's lawyer should not have dealt with the company through his partner who serves on the board, but rather through the lawyer representing the trust company).

6. As in other areas, lawyers must check the approach taken by the applicable bar before deciding whether they can become adverse to the corporation on whose board they or one of their partners serves. Given the high stakes involved, they probably should also check the pertinent bar's attitude before agreeing to serve on a corporate board.

VII. ORGANIZATION AS CLIENT

A. Model Rule 1.13 deals with a situation in which a lawyer is employed or retained by an organization. This Model Rule may impact the services that a lawyer representing a closely held business can handle for an organization and the shareholders or partners or other members of such an organization.

B. Model Rule 1.13(a) states that a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents. Model Rule 1.13(f) deals with the potential conflict or actual conflict between organization and others. It states:

> In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interest are adverse to those of the constituents with whom the lawyer is dealing.

C. Model Rule 1.13(g) states that a lawyer representing an organization may represent any of its directors, officers, employees, members, shareholders or other constituents subject to the provisions of Model Rule 1.7.

D. The Model Rules define an organization as a corporation, partnership, limited liability company or an unincorporated association. As noted above, a lawyer under Model Rule 1.7 may not undertake a representation that is directly adverse to a current client or may be materially limited by the lawyer's responsibility to another client absent consent after representation.

E. Often times it may not be clear that an attorney client relationship has been formed by either express agreement or by implication. This issue will often arise when there is a falling out among the shareholders and a closely held corporation and the corporate counsel is aligned with one faction, which often maybe the controlling shareholders. Some factors that have led courts to decide that an attorney client relationship has been formed between the corporate counsel and a constituent include:

- Frequent contact between corporate counsel and the constituent during counsel's representation of the corporation;
- Past representation of constituent by corporate counsel, whether or not the matters are related;
- Particular interest of a constituent in the matter at issue;
- Failure of the constituent to retain his or her own lawyer;
- Advice provided by corporate counsel to the constituent;
- Disclosure of confidences by the constituent to corporate counsel;
- Payment by the constituent of some portion of a corporate counsel fee; and
- Absence of any statement by corporate counsel about which entities or constituents were his or her clients.

F. Paula Blagger discusses various important considerations representing closely held entities and their constituents in her article on this. [48]

1. No matter how small the non-controlling interests, a closely held corporation is a separate entity from its shareholders and is entitled to separate representation.

2. Every shareholder must understand that, unless a joint representation has been undertaken, corporate counsel's primary obligation is to the corporation.

3. Corporate counsel should confirm in a written engagement letter the identity of his or her client.

4. Particularly if there are any special circumstances, corporate counsel should confirm in writing who is not his or her client.

5. Whenever dealing with a constituent whose interests are potentially adverse, corporate counsel should explain that counsel represents the corporation and not the constituent.

6. Corporate counsel may represent constituents as well as the corporation if the conflict rules in Model Rule 1.7 are satisfied. Any conflict waiver must be given by an authorized representative of the corporation other than the one counsel is seeking to represent.

7. The possibility of conflict increases if corporate counsel has represented some or all of the constituents in creating the corporation or drafting agreements among the constituents. This also increases the possibility of winding up on one or more witness lists.

8. Corporate counsel must be aware of special circumstances creating a duty to non-client constituents.

9. Corporate counsel should observe corporate formalities and insist on compliance with corporate governance documents.

10. Corporate counsel should only take direction from duly authorized constituents and document their instructions.

[48] "Ethical Issues Facing Corporate Counsel in Closely Held Business Disputes," Commercial and Business Litigation, Winter 2015, Volume 16, Number 2 (February 23, 2015).

VIII. REPRESENTING FAMILIES IN FAMILY LIMITED PARTNERSHIPS.

A. One of the most popular estate planning tools in recent years and one that is used extensively in connection with transfers between family members is the family limited partnership and the related limited liability company. One of the best discussions of the ethical conflicts involved with one lawyer representing multiple family members in the formation and operation of a family limited partnership or limited liability company is found in a 2009 article by Mary F. Radford.[49] It is common for the formation of a family limited partnership to arise as part of the overall estate plan of one or more senior family members. The lawyer who represents senior family members may also be likely, as the "family lawyer," to also represent other members of the family in personal matters. This creates the potential for a conflict of interest and for difficulties in dealing with family information.[50] As Professor Radford notes, when family relationships start to disintegrate or go awry, the lawyer who represented different members of the family might find himself or herself in a difficult position. Simple withdrawal may not be sufficient, for example as a lawyer representing all the partners might have a duty to disclose partnership information to all of the partners even though one partner insists on keeping the information confidential.

B. Professor Radford suggests that in these situations the lawyer should help the multiple clients to understand the matrix of the relationships and agree to ground rules that cover the duties the lawyer has with respect to client information. The lawyer should memorialize all of the agreements of the different clients in writing. Professor Radford believes that the advance diligence, while it will not ward off all possible future dissention, will promote deliberation by clients and the lawyer before the representation begins and will provide a framework in which to deal with future disagreements.[51]

C. One fundamental issue is whether the lawyer represents the entity or the partners or members of the entity. Model Rule 1.13(a) states that: "a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." Model Rule 1.13(e) states that:

[49] Mary F. Radford. "Ethical Challenges in Representing Families and Family Limited Partnerships", 35 ACTEC Journal 2 (2009). (Hereafter "Radford").

[50] Radford, at 28.

[51] Radford at 9.

> A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization of the individual who is to be represented or by the shareholders.

D. The ACTEC Commentary on Model Rule 1.13 states that the lawyer who represents a corporation, partnership, or limited liability company may appropriately undertake to represent individuals who are interested in the business or who are employed by it, provided that they comply with the other ethical rules, especially Model Rule 1.6 on confidential information and Model Rule 1.7 on conflicts of interest between current clients.

1. The common interest in multiple clients with respect to matters concerning the business or family enterprise may predominate over any separate interests that they may have. Multiple representations in such cases may be in the best of interest of the clients and may provide them with better and more economical representation.

2. The ACTEC Commentary then goes on to say that the lawyer with informed consent confirmed in writing of the business enterprise and an employee may represent both with respect to matters that affect both. If their interests are not seriously adversarial.

E. One question that arises is whom the lawyer for a general partnership or a limited partnership represents. For example, Professor Radford in her article describes that the question of whom a lawyer represents when he or she represents a partnership has a number of possible answers:

1. The lawyer represents only the partnership which is a separate entity from its partners; and

2. The lawyer represents each of the individual partners because a partnership has no separate "entity" status; and

3. The lawyer represents the partnership as an entity and by extension each of the partners; and

4. The answer depends on the peculiar circumstances of each case.

F. Professor Radford notes that answering this question is required to determine to whom the lawyer owes the duty to communicate under Model Rule 1.4, the duty of confidentiality under Model Rule 1.6, and the duty to avoid conflicts of interest under Model Rule 1.7.

G. Professor Radford proposes that the answers may differ depending upon whether a general partnership or a limited partnership is formed.

1. One approach is that the lawyer represents only the entity as a separate client of the lawyer.

2. However, in Responsible Citizens vs. Superior Court,[52] a California court opted for a case by case analysis and examined four factors with respect to a general partner.

a. The type and size of the partnership;

b. The nature and scope of the lawyer's engagement by a partnership;

c. The kind and extent of contacts of any between the lawyer and a mutual partner;

d. The lawyer's access to information relating to the individual partner's interest.

3. In Responsible Citizens v. Superior Court,[53] the court found that a lawyer representing a partnership does not necessarily have a lawyer-client relationship with an individual partner for purposes of applying conflict of interest rules. ABA Formal Opinion 91-361 states that "An attorney-client relationship does not automatically come into existence between a partnership lawyer and one or more of its partners .... Whether such a relationship has been created almost always will depend on an analysis of the specific facts involved."

H. Limited Partnerships. Professor Radford notes that courts differ in their determinations of whether a lawyer who represents a limited partnership represents the limited partnership alone; the partnership and the general partner concurrently; or the partnership and all of the partners, both general and limited, concurrently.

1. The majority of the cases take the position that the lawyer for the limited partnership does not represent the limited partners. Other courts have held that the lawyer for a limited partnership has a duty of care to limited partners regardless of whether the lawyer was the

[52] 20 Cal Rptr 2d. 756 (1993)

[53] 20 Cal. Rptr. 2d 756 (Cal. App. 1993)

lawyer for the partnership or general partner. See Arpadi v. First MSP Corp.[54]

2. Representing a Partnership and Individual Partners - The increasing use of family limited partnerships as an estate planning tool carries with it the chance of ensnaring a lawyer in conflicts of interest.

   a. Griva v. Davison,[55] provides an example of a law firm caught up in a family dispute. Lawyer Davison and his law firm became involved with the Maiatico family in connection with some litigation over a commercial building owned by the patriarch of the family. During the litigation, questions of the father's capacity arose and the firm instituted a guardianship proceeding. The firm prepared an estate planning memorandum in connection with the guardianship recommending that the commercial real estate be placed in a family limited partnership.

      (1) Two of the patriarch's three children, Ann and Michael Maiatico, looked solely to Davison and his firm for legal advice. The third child, Rose Griva, however, consulted with independent counsel. All three retained Davison to draft the partnership agreement and form the entity. The three children were general partners. At the insistence of Griva's separate counsel, a unanimous consent provision was included in the partnership agreement, such that any one general partner could deadlock the partnership.

      (2) After formation of Maiatico Family Limited Partnership (MFLP), Davison continued as general counsel to MFLP and represented all three siblings on family matters. Davison also advised the two Maiaticos as general partners, as well as on individual matters.

         (A) Numerous disputes arose among the partners regarding the redevelopment of the partnership real estate and the partners were frequently deadlocked. The Maiaticos

[54] 628 N.E. 2d. 1335 (Ohio 1994)

[55] 637 A.2d 830 (D.C. App. 1994)

wished to grant the lessee of MFLP's building the right to sublet and manage the property. The effect of this transaction would have been to decrease the management power Griva was able to exercise due to the unanimous consent provision in the partnership agreement.

(B) The law firm's bills started to raise Griva's suspicions about Davison's advice to her siblings. Entries referenced a memorandum about "dissolution of [the] deadlocked MFLP" and conversations with the Maiaticos about "dissolving MFLP."

(3) These events led Griva to request access to all of the Davison's firm's files on MFLP. When the firm refused, Griva filed suit alleging that Davison and his firm had violated the conflict of interest provisions of the Code of Professional Responsibility. On appeal, the court found that it did not need to resolve the question of whether Griva was a formal client of the firm after the formation of MFLP because the structure of MFLP made Griva "functionally" a client of the firm. Because Griva could deadlock MFLP when she disagreed with her siblings, she had the power to keep MFLP at odds with the wishes of her siblings. Therefore, rather than analyzing the situation as a potential conflict between Griva and the Maiaticos, the court addressed the ethical issue presented by the law firm's representation of MFLP and the Maiaticos as general partners.

(4) The court noted, "a lawyer for an entity cannot represent constituents of an entity when such representation may prejudice the interests of that entity, or when it is unclear what constituents represent the interests of the entity and thus a dispute between constituents makes it impossible to know what the entity's interests are."[56] The court determined that there were genuine issues of fact regarding whether Davison fully disclosed to Griva the conflict of interest involved in representing both

[56] 637 A.2d at 840.

her and MFLP and whether Griva consented to the joint representation.

b. Arpadi v. First MSP Corporation,[57] involved a limited partnership among investors rather than family members, but its holding may have profound implications for lawyers who represent family limited partnerships.

(1) Lawyer Richard Jankel served as counsel, president and director of the general partner in Lakeside Apartments, L.P. The partnership was formed for the purpose of acquiring and developing an apartment complex. Investments in the partnership were solicited by means of a private placement memorandum (PPM). The PPM provided that the partnership would purchase the complex and renovate some units. The liens on those units would be released to permit their sale as condominiums. The proceeds would then be used to renovate additional units.

(2) After the plaintiffs invested in the partnership as limited partners, the existing mortgage holders on the complex refused to agree to the release formula. Jankel participated in the preparation of a purchase agreement that omitted any release formula. The limited partners were not informed of the omission. After the project ended in bankruptcy, the limited partners alleged that the lack of a mechanism for the release of liens on portions of the complex denied the project cash flow and caused its failure.

(3) The plaintiffs argued that Jankel, as lawyer for the partnership, owed a duty of care to the limited partners. The court agreed, noting that state law determines whether a partnership is treated as an entity, like a corporation, or as an aggregate of individuals.[58]

3. When representing multiple family members or partnerships and individual partners, the lawyer should assess each individual transaction and determine whether certain family members or

[57] 628 N.E.2d 1335 (Ohio 1994)

[58] See also Pucci v. Santi, 711 F. Supp. 916 (N.D. Ill. 1989) (representation of partnership includes fiduciary duty to all partners on partnership matters).

partners should seek independent counsel because of the potential for conflicts arising.

IX. CURRENT CLIENTS: CONFLICT OF INTEREST

A. Lawyers doing business with their clients confront both fiduciary duty and ethics challenges.

B. As a matter of common law fiduciary duty, lawyers entering into business transactions with their clients normally are presumed to have defrauded them -- and must overcome that presumption with clear and convincing evidence.

1. Liggett v. Young[59] addressed the contract between a lawyer and client contractor for the construction of the lawyer's home and reversed the trial court's award of summary judgment to the lawyer in a breach of contract action brought by the contractor. The court noted that the argument pursued by the lawyer that the contract with his client/contractor fell within the "standard commercial transaction" exception to Rule 1.8(a), but also acknowledged that the contractor argued that the exception was inapplicable because the lawyer had drafted the contract. It held that a violation of the ethics rules does not support a cause of action, but that the contractor/client could rely upon a common law breach of fiduciary duty claim against the lawyer; explaining that contracts between fiduciaries and beneficiaries are "presumptively invalid" and that "[t]ransactions between an attorney and client are presumed to be fraudulent, so that the attorney has the burden of proving the fairness and honesty thereof."

2. In Tower Investors, LLC v. 111 E. Chestnut Consultants, Inc.[60] the court held that a partner of the Chicago law firm of Sonnenschein, Nath & Rosenthal (who had invested in a law firm client through an entity separate from the law firm) could enforce a promissory note; explaining that "attorney-client transactions are not void, but rather, presumptively fraudulent"; explaining that the sophisticated client had not been defrauded, because the law firm had fully explained the conflict.

C. Building on this common law fiduciary duty principle, Model Rule 1.8 (a) contains a remarkably stringent standard for business transactions between lawyers and their clients.

[59] 877 N.E.2d 178, 184, 185 (Ind. 2007).

[60] 864 N.E.2d 927, 943 (Ill. App. Ct.).

> (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless
>
> > (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
> >
> > (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
> >
> > (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

D. Not surprisingly, this rule does not apply

> to standard commercial transactions between a lawyer and a client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has not advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable.

E. The Restatement of the Law Governing Lawyers takes the same basic approach as the ABA Model Rules, but without the mandatory written disclosures and consents.

> A lawyer may not participate in a business or financial transaction with a client, except a standard commercial transaction in which the lawyer does not render legal services, unless:
>
> > (1) the client has adequate information about the terms of the transaction and the risks presented by the lawyer's involvement in it;

(2) the terms and circumstances of the transaction are fair and reasonable to the client; and

(3) the client consents to the lawyer's role in the transaction under the limitations and conditions provided in § 122 after being encouraged, and given a reasonable opportunity, to seek independent legal advice concerning the transaction.[61]

F. Every state has a rule dealing with lawyers doing business with their clients. These usually fall somewhere between the ABA Model Rules and the Restatement.

1. States have severely punished lawyers who violate the applicable rules.

a. In re Conduct of Hostetter,[62] suspending for 150 days a lawyer who "represented the borrower in the underlying loan transaction" and then "subsequently represented the lender in collecting the loans from the borrower's estate"; "This case presents a matter of first impression in Oregon -- that is, whether a former client, now deceased, is protected by the former-client conflict-of-interest rules. Oregon is not alone, as no jurisdiction appears to have directly addressed the issue. At best, a few jurisdictions have addressed the related issue of whether dissolved corporations are 'clients' for purposes of the former-client conflict-of-interest rules. Those jurisdictions are split on the issue. Some jurisdictions hold that, upon a corporation's dissolution, a conflict of interest cannot exist, because the entity is 'dead,' no longer exists, and, accordingly, cannot have interests adverse to the current client. . . . Conversely, other jurisdictions hold that a bankruptcy trustee 'stands in the shoes' of the corporation as former client, and the accused in later litigation may not represent an interest adverse to the successors in interests of the failed corporation."; "[W]e conclude that, pursuant to DR 5-105(C) and RPC 1.9(a), an attorney is prohibited from engaging in a former-client conflict of interest even when the former client is deceased, as long as the former client's interests survive his or her death and are adverse to the current client during the subsequent representation.";

[61] Restatement (Third) of Law Governing Lawyers § 126 (2000).

[62] 238 P.3d 13, 15, 18, 20, 24 (Or. 2010

> "The debt collection and loan transactions certainly involved the same transaction -- the underlying loan documents that the accused drafted on behalf of Ingle [deceased client]. The accused's representation of Hohn [lender to deceased client] involved his own work that he had completed on behalf of Ingle and, in that regard, the matters are substantially related. We therefore determine that the accused engaged in a matter-specific conflict in violation of RPC 1.9(a)."

b. Office of Lawyer Regulation v. Trewin,[63] suspending for five months a lawyer who engaged in a business transaction with a client without following the Wisconsin rule requiring lawyers to advise their clients in writing of the possible adverse effects of the relationship.

c. Fair v. Bakhtiari,[64] addressing a situation in which a lawyer and client entered into a successful real estate business venture; explaining that the lawyer could not recover under a quantum meruit theory when the client rescinded the business venture, because the lawyer had not complied with the ethics rules governing business with clients.

2. Some courts give the client even a better deal -- finding the arrangement voidable by the client.

a. BGJ Assocs. LLC v. Wilson,[65] holding that a lawyer's transaction with a former client was voidable because the lawyer had not made the necessary disclosures in writing, and had not obtained the client's consent in writing.

b. Petit-Clair v. Nelson,[66] holding that clients could void a mortgage on their personal residence that they had given their lawyer to secure payment of legal fees; explaining that the lawyer had not advised the client of the advisability of seeking independent counsel in the transaction. This approach allows clients to enforce favorable arrangements, while voiding unfavorable deals.

[63] 684 N.W.2d 121 (Wis. 2004).

[64] 125 Cal. Rptr. 3d 765 (Cal. Ct. App. 2011).

[65] 7 Cal. Rptr. 3d 140 (Cal. Ct. App. 2003).

[66] 782 A.2d 960 (N.J. 2001).

G. Under Model Rule 1.8(k), the prohibition involving a lawyer doing business with a client applies to all lawyers in the same firm.

X. MISCELLANEOUS RULES ON CONFLICTS OF INTEREST

A. Payment of Lawyer's Fees by Others

1. Model Rule 1.8 sets forth a number of specific rules related to conflicts of interest for current clients. Of particular interest to this discussion is Model Rule 1.8(f), which provides:

a. A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of a client is protected as required by Rule 1.6.

2. The ACTEC Commentary on this provision notes that "[i]t is relatively common for a person other than the client to pay for the client's estate planning services." The examples included in the ACTEC Commentary make clear that in such situations, the lawyer must inform the individual paying his or her fees of the requirements of Rule 1.8 and must also obtain the informed consent of their client. If the lawyer believes there is significant risk that their representation of the client will be materially limited by the fact that the fees are paid by someone else, then the consent must be confirmed in writing.

3. A common example of when someone other than the client might pay for estate planning services is when a parent pays for estate planning for a child or a child pays for the estate planning for a parent.

B. Cases on Accepting Payment from Persons Other than Client

1. There are few reported cases dealing with the issue of an estate planning lawyer being paid by a party other than his client. Perhaps this is the case because such arrangements are relatively common.

2. A case out of the Supreme Court of Louisiana addressed the issue under a unique set of facts. In Succession of Wallace[67], Charles Wallace's will appointed his wife, Ruth, as executor of his estate and appointed Jacqueline Goldberg to act as lawyer for the executor and estate. During the probate process, Ruth wanted to discharge Goldberg and employ a lawyer of her choice. Louisiana had a statute which provided that a lawyer designated by a testator in his will may be removed as such only for just cause.

3. The Louisiana Supreme Court struck this law as being null and void as it was in irreconcilable conflict with rules requiring a lawyer to withdraw from a representation if he or she is discharged by a client. In arguing that she should be retained as counsel to the executor, Goldberg argued that because the lawyer will be paid with succession funds from the estate, Rule 1.8(f) indicated that the testator is the client, not the executor. The court did not accept this argument, noting that "it is the executor's duty to pay the lawyer's fee with succession funds as a debt of the succession. . . . The only person or legal entity involved who can act as a client in paying the lawyer is the executor."

C. Duties to Former Clients

1. Model Rule 1.9 provides:

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter, unless the former

[67] 574 So.2d 348 (1991).

client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

2. An example provided in the ACTEC Commentary to Model Rule 1.9 demonstrates how this Rule may be implicated by a joint representation. In the example, the lawyer represented husband and wife jointly in estate planning matters. Husband and wife subsequently divorce, at which point the lawyer continues to represent the husband in estate planning and other matters. Because wife is a former client, Model Rule 1.9 imposes limitations on the lawyer's representation of husband. Unless wife gives informed consent, confirmed in writing, the lawyer would be unable to represent husband in a matter substantially related to the prior representation in which husband's interests are materially adverse to wife's, such as an attempt to terminate an irrevocable trust benefiting wife.

D. Cases on Duties to Former Clients

1. A lawyer's role representing individuals and estates may also result in precluding the lawyer from certain representations. In Galiardo v. Caffrey[68], an Illinois trial court granted a motion to disqualify a lawyer who formerly represented an estate from representing the executor individually in a beneficiary's action against her. In Gagliardo, Michael Gagliardo's sister, Paulette, became the sole trustee of his revocable trust and executor of his estate upon his death. Michael's wife, Margaret and their children were the sole beneficiaries of the trust.

2. Unhappy with Paulette's service as trustee and executor, Margaret brought an action to remove Paulette as trustee and executor.

[68] 800 N.E.2d 489 (Ill. App. 2003).

Paulette was represented in her individual capacity by lawyer Christopher Matern. Margaret then filed a motion to disqualify Matern based on Matern's representation of Michael's estate. The trial court granted Margaret's motion to disqualify Matern for the representation under Rule 1.9, which prohibits a lawyer from representing one client whose interests are adverse to a former client. The appellate court affirmed the trial court's decision, concluding that for the time Matern represented the estate, he represented Margaret as its sole beneficiary thereby precluding him from representing Paulette in Margaret's action against her.

E. Duties to Prospective Clients.

1. Model Rule 1.18 ("Duties to Prospective Client") starts with the bedrock principle that a person will be considered a "prospective client" if the person discusses with a lawyer "the possibility of forming a client-lawyer relationship." Model Rule 1.18(a). The lawyer must treat such a person as a former client for conflicts purposes.[69]

2. In a comment, Model Rule 1.18 provides some guidance that could apply to unsolicited emails.

> Not all persons who communicate information to a lawyer are entitled to protection under this Rule. A person who communicates information unilaterally to a lawyer, without any reasonable expectation that the lawyer is willing to discuss the possibility of forming a client-lawyer relationship, is not a "prospective client" within the meaning of paragraph (a).[70]

3. A lawyer may not represent the adversary in the same or substantially related matter -- if "the lawyer received information from the prospective client that could be significantly harmful to that person in the matter."[71]

4. This would allow more flexibility to the lawyer than the standard rule, which would have prevented the lawyer's representation of the adversary if the lawyer had received any confidential information from the prospective client -- not just information that "could be significantly harmful" to the prospective client.

[69] Model Rule 1.18(b).

[70] Model Rule 1.18, Comment

[71] Model Rule 1.18(c).

5. Finally, any individual lawyer's disqualification even under that standard is not imputed to the entire law firm if the lawyer had taken "reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client," and if the individually disqualified lawyer is screened from the matter (including financially screened) and provides written notice to the prospective client.[72]

F. File Ownership.

1. Lawyers must sometimes determine what part of their files they must turn over to a client who has fully paid the lawyers' fees. The issue becomes more complicated, and certainly more acute, if lawyers want to assert a lien over clients' files because the lawyers have not been paid. This is frequently called a "retaining lien." It differs from what many call a "charging lien," which lawyers may sometimes assert over a judgment or other client property other than clients' files.

2. In dealing with the ethics side of this issue, the ABA Model Rules takes a surprisingly neutral and state-specific approach.

> Upon termination of representative, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as . . . surrendering papers and property to which the client is entitled . . . . The lawyer may retain papers relating to the client to the extent permitted by other law.[73]

3. The Restatement also deals with this issue -- in much more detail than the ABA Model Rules.

   a. The Restatement requirement that the lawyer provides documents in the lawyer's possession is subject to the lawyer's right to

   > decline to deliver to a client or former client an original or copy of any document under circumstance permitted by § 43(1) [which deals

[72] Model Rule 1.18(d)(2).

[73] Model Rule 1.16(d)

> with the lawyer's ability to retain documents until the lawyer is paid].[74]

b. Another Restatement section discusses a lawyer's general right to obtain a security interest in any property that the client owns or might acquire (not just a file).

> Unless otherwise provided by statute or rule, client and lawyer may agree that the lawyer shall have a security interest in property of the client recovered for the client through the lawyer's efforts, as follows: (a) the lawyer may contract in writing with the client for a lien on the proceeds of the representation to secure payment for the lawyer's services and disbursements in that matter; (b) the lien becomes binding on a third party when the party has notice of the lien; (c) the lien applies only to the amount of fees and disbursements claimed reasonably and in good faith for the lawyer's services performed in the representation; and (d) the lawyer may not unreasonably impede the speedy and inexpensive resolution of any dispute concerning those fees and disbursements or the lien.[75]

c. Some courts and bars cling to the traditional approach -- essentially allowing lawyers to retain documents until the client fully pays the lawyers' bills.

(1) Grimes v. Crockrom,[76] holding that a lawyer could assert a retaining lien even if the lawyer did not provide a detailed record of the lawyer's work to the client; "A common law retaining lien on records in the possession of an attorney arises on rendition of services by the attorney. . . . Crockrom does not direct us in any legal authority tying the validity of a retaining lien to the provision of an itemized bill to the client. Indeed, a retaining lien is complete and effective without notice to anyone. . . . And the reasonableness of a fee, as reflected by an attorney's lien, is irrelevant to the determination of whether the lien has been established. . . . We hold that

[74] Restatement (Third) of Law Governing Lawyers § 46(4) (2000).

[75] Restatement (Third) of Law Governing Lawyers § 43(2) (2000).

[76] 947 N.E.2d 452, 454-55 (Ind. Ct. App. 2011).

Grimes has a valid retaining lien over the medical records." (emphasis added).

(2) SEC v. Ryan,[77] analyzing a situation in which a law firm represented an individual and an LLC; concluding that the LLC's receiver became a client when the LLC declared bankruptcy; concluding that the law firm jointly represented the individual and the LLC; "On the other hand, every attorney has a common-law retaining lien upon the books and records in his possession and such lien exists independently of the rights created by statute."; "As a general proposition, before a lawyer is required to surrender the files, which are subject to this lien, to either the client or a substituted attorney, the outstanding legal fees must be paid or adequate security for the payment must be posted." (emphasis added).

d. Those courts and bars which have moved away from the traditional "auto mechanic" approach to a retaining lien sometimes articulate standards under which the client can obtain the file without paying for it. These standards represent a spectrum of the type of prejudice the client must claim before the lawyer becomes ethically obligated to turn over the file even if the client has not paid his bills. Bars and courts have articulated the following standards:

(1) Substantial Prejudice

(2) Prejudice

(3) Harm

e. Some states have adopted specific proceedings for asserting such retaining liens. See Alaska LEO 2012-1 (1/27/12) (holding that Alaska law did not allow a lawyer's recording of a lien for attorney's fee; "Recording a lien for attorneys' fees pursuant to AS 34.35.430 violates Alaska Rules of Professional Conduct 1.5, 1.8 and 1.16."; "Alaska Statute 34.35.430 sets out the procedure for asserting an attorney lien for fees against client papers or money in possession of the lawyer or an adverse party. Unlike other lien statutes of Chapter 35, AS 34.35.430 does not reference recording.

[77] 747 F. Supp. 2d 355, 361, 369 (N.D.N.Y. 2010).

> One court has specifically held that AS 34.35.430 does not authorize the recording of an attorney lien."; "If an attorney wishes the security of a recordable lien on real property, the attorney has the ability to do so notwithstanding this opinion. The attorney can reduce the fees claimed in the lien to judgment with the final judgment being recorded. Because this procedure requires that the client be advised of the fee arbitration procedure and accords the client a full opportunity to respond to the fee claim, this is the appropriate procedure to accomplish this goal.").

XI. DEALING WITH UNREPRESENTED PERSONS

A. Model Rule 4.3

1. Model Rule 4.3 provides:

> In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer’s role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

2. The ACTEC Commentary on Rule 4.3 notes that a lawyer for a fiduciary is required to comply with Rule 4.3 and that in doing so, the lawyer should inform the beneficiaries of the fiduciary estate regarding various matters, including the fact that the lawyer does not represent them and that they may wish to obtain independent counsel.

B. Case on Dealing with Unrepresented Persons

1. Courts do not take kindly to counsel who do not take the appropriate steps in dealing with unrepresented persons. In fact, courts often raise the issue *sua sponte*, and in doing so, often direct the court’s clerk to notify the state bar of the lawyer’s conduct.[78]

[78] See, e.g., In re Jumper, 984 A.2d 1232 (D.C. App. 2009).

2. In Estate of Hydock[79], the court addressed the "tangential" issue of the conduct of a lawyer who prepared a disclaimer of interest in an estate to be executed by a beneficiary the lawyer knew was unrepresented and impaired. The court found it "clear that [the lawyer] had a duty under Rule 4.3 . . . to advise [the beneficiary], an unrepresented person, to retain counsel."

XII. MULTI JURISDICTIONAL ISSUES

A. Estate planning transactions often involve family members who reside in more than one jurisdiction. In these situations, lawyers must be aware of the issues raised in representing clients who reside outside a jurisdiction in which the lawyer is licensed.

B. ABA Model Rules of Professional Conduct. The Model Rules were adopted by the House of Delegates of the American Bar Association on August 2, 1983, and amended from time to time thereafter. The Model Rules (or variations thereof) are now in force in forty-four states.

1. Rule 5.5 deals with the unauthorized practice of law. The original version of Rule 5.5 reads:

> A lawyer shall not
>
> (1) practice law in a jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction; or
>
> (2) assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law.
>
> ABA Model Rules, Rule 5.5.

2. The original version of Model Rule 5.5, as can be seen, is quite similar to DR 3-101 of the Model Code.

3. Ethics 2000 Commission. In late 1997, the ABA established the Commission on the Evaluation of the Rules of Professional Conduct, popularly known as the "Ethics 2000 Commission," to examine the existing Model Rules of Professional Conduct and propose changes to them, giving special attention to, among other

[79] 2004 Phila Ct. Com. Pl. LEXIS 144 (Feb. 22, 2004).

topics, interstate practice and multistate law firms.[80] The Ethics 2000 Commission submitted a report to the ABA House of Delegates at the August 2001 meeting. The report was debated at both the August 2001 and February 2002 meetings and the recommendations were finalized at the February 2002 meeting.

4. Commission on Multi-Jurisdictional Practice. In July 2000, the ABA appointed a Commission on Multi-Jurisdictional Practice which proposed substantial changes to Rule 5.5. These changes were adopted at the August 2002 meeting of the ABA. Since the adoption, these changes have been adopted in 34 states and the District of Columbia and were pending (as of September 25, 2007) in 6 states.

C. Amended Model Rule 5.5 reads:

(a) A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so.

(b) A lawyer who is not admitted to practice in this jurisdiction shall not:

(1) except as authorized by these Rules or other law, establish an office or other systematic and continuous presence in this jurisdiction for the practice of law; or

(2) hold out to the public or otherwise represent that the lawyer is admitted to practice law in this jurisdiction.

(c) A lawyer admitted to another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that:

(1) are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter;

[80] See, e.g., Robert A. Stein, “Updating Our Ethics Rules”, ABA Journal, Aug. 1998, at p. 106, Demetrios Dimitriou, “Legal Ethics in the Future: What Relevance?”, Prof. Law., Spring 1998, at p. 2.

(2) are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in such proceeding or reasonably expects to be so authorized;

(3) are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and are not services for which the forum requires *pro hac* vice admission; or

(4) are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

(d) A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services in this jurisdiction that:

(1) are provided to the lawyer's employer or its organizational affiliates and are not services for which the forum requires *pro hac vice* admission; or

(2) are services that the lawyer is authorized to provide by federal law or other law of this jurisdiction.

D. Amended Rule 5.5 greatly expands Rule 5.5 by providing several ways in which an out-of-state lawyer could practice in the state. The two important parts of Amended Rule 5.5 for tax practitioners are:

1. Amended Rule 5.5(c)(3) permitting an out-of-state lawyer to provide representation to clients in pending or anticipated arbitrations, mediations, or other alternative dispute resolution proceedings; and

2. Amended Rule 5.5(c)(4) which permits, on a temporary basis, transactional representation, counseling and other non-litigation work that arises out of or is reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

E. Reasons behind Amended Rule 5.5(c)(4):

1. Drawn from § 3(3) of the Restatement (Third) of the Law Governing Lawyers.

2. Emphasizes need to have a single lawyer conduct all aspects of a transaction.

3. Respect preexisting and on-going client/lawyer relationships. According to the Report, clients are better served by having a sustained relationship with a lawyer or law firm in whom the client has confidence.

4. Permits a client to engage a person with a recognized expertise in a particular body of law.[81]

F. One issue is when work outside a lawyer's home state is "reasonably related" to a lawyer's work in the home state. The MJP Report provides little guidance on this. Instead, it states that judgment must be exercised.[82]

G. Thirteen states have adopted a rule identical to Amended Model Rule 5.5:

Alaska
Arkansas
Illinois
Indiana
Iowa
Maryland
Massachusetts
Nebraska
New Hampshire
Rhode Island
Utah
Vermont
Washington

H. Thirty states and the District of Columbia have adopted a rule similar to Amended Model Rule 5.5:

Alabama
Arizona
California
Colorado
Connecticut
Delaware
District of Columbia
Nevada
New Jersey
New Mexico
North Carolina
North Dakota
Ohio

[81] American Bar Association Center for Professional Responsibility, Client Representation in the 21st Century. Report of the Committee on Multijurisdiction Practice. (2002) at 27-28 (hereafter "MJP Report")

[82] MJP Report, at 29.

Florida
Georgia
Idaho
Kentucky
Louisiana
Maine
Michigan
Minnesota
Missouri
Oklahoma
Oregon
Pennsylvania
South Carolina
South Dakota
Tennessee
Virginia
Wisconsin
Wyoming

I. Also in 2002, upon the recommendation of the Commission on Multi-Jurisdictional Practice, the ABA adopted Amended Rule 8.5 to clarify the authority of a jurisdiction to discipline lawyers licensed in another jurisdiction who practice law within their jurisdiction pursuant to the provisions of Rule 5.5 or other law. This was done to alleviate the perceived problems with lawyers only being subject to discipline in states in which they are licensed.

1. Amended Model Rule 8.5 reads as follows:

(a) Disciplinary Authority. A lawyer admitted to practice in this jurisdiction is subject to the disciplinary authority of this jurisdiction, regardless of where the lawyer's conduct occurs. A lawyer not admitted to this jurisdiction is also subject to the disciplinary authority of this jurisdiction if the lawyer provides or offers to provide any legal services in this jurisdiction. A lawyer may be subject to the disciplinary authority of both this jurisdiction and another jurisdiction for the same conduct.

(b) Choice of Law. In any exercise of the disciplinary authority of this jurisdiction, the rules of professional conduct to be applied shall be as follows:

(1) for conduct in connection with a matter pending before a tribunal, the rules of the jurisdiction in which the tribunal sits, unless the rules of the tribunal provide otherwise; and

(2) for any other conduct, the rules of the jurisdiction in which the lawyer's conduct occurred, or, if the predominant effect of the conduct is in a different jurisdiction, the

> rules of that jurisdiction shall be applied to the conduct. A lawyer shall not be subject to discipline if the lawyer’s conduct conforms to the rules of a jurisdiction in which the lawyer reasonably believes the predominant effect of the lawyer’s conduct will occur.

2. Twenty-four states have adopted a rule identical to Amended Rule 8.5.

Alaska
Arizona
Arkansas
Connecticut
Idaho
Illinois
Iowa
Kentucky
Louisiana
Maine
Michigan
Minnesota
Missouri
Nebraska
Ohio
Oklahoma
Oregon
Pennsylvania
Rhode Island
South Dakota
Utah
Vermont
Washington

3. Twenty-one states have adopted a rule similar to amended Model Rule 8.5.

California
Colorado
District of Columbia
Florida
Georgia
Indiana
Maryland
Massachusetts
Montana
Nevada
New Hampshire
New Jersey
New Mexico
New York
North Carolina
North Dakota
South Carolina
Tennessee
Virginia
Wisconsin
Wyoming

4. Amended Model Rule 8.5 has been recommended in Mississippi and West Virginia.

XIII. CLIENTS WITH DIMINISHED CAPACITY

A. Model Rule 1.14 provides:

> (a) When a client's capacity to make adequately considered decisions in connection with a representation is diminished, whether because of minority, mental impairment or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.
>
> (b) When the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client and, in appropriate cases, seeking the appointment of a guardian ad litem, conservator or guardian.
>
> (c) Information relating to the representation of a client with diminished capacity is protected by Rule 1.6. When taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized under Rule 1.6(a) to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests.

B. When dealing with a client with diminished capacity, the ACTEC Commentary notes that a lawyer:

> has implied authority to make disclosures of otherwise confidential information and take protective actions when there is a risk of substantial harm to the client. Under those circumstances, the lawyer may consult with individuals or entities that may be able to assist the client, including family members, trusted friends and other advisors.”

C. In Moore v. Anderson Ziegler Disharoon Gallagher & Gray, PC[83], the adult children of a decedent brought a malpractice action against a lawyer alleging that the lawyer was negligent in failing to determine whether the decedent had testamentary capacity at the time the decedent executed a new will and amended his trusts. The trial court dismissed the children’s complaint and the court of appeals affirmed. The adult children based their claim of negligence in part on Model Rule 1.14 and the ACTEC

[83] 100 Cal. App. 4th 1287 (2003).

Commentary on Rule 1.14, arguing that the Rule and Commentary require an estate planning lawyer to determine that his or her client has testamentary capacity when executing a will or dispositive instrument and that when there is a doubt, a competent lawyer should take reasonable steps to confirm the client's capacity. The court dismissed this argument, noting that any such duty runs to the testator, not the beneficiaries.

XIV. LAWYER AS WITNESS

A. A lawyer may end up being a witness, often if an estate planning technique does not work as anticipated by one or more of the parties.

B. Model Rule 3.7 provides:

> (a) A lawyer shall not act as advocate at a trial in which the lawyer is likely to be a necessary witness unless:
>
> (1) the testimony relates to an uncontested issue;
>
> (2) the testimony relates to the nature and value of legal services rendered in the case; or
>
> (3) disqualification of the lawyer would work substantial hardship on the client.
>
> (b) A lawyer may act as advocate in a trial in which another lawyer in the lawyer's firm is likely to be called as a witness unless precluded from doing so by Rule 1.7 or Rule 1.9.[84]

C. Problems implicating Model Rule 3.7 typically arise in estate and trust litigation matters such as will contests, surcharge actions and trust interpretation cases. These types of cases frequently involve the lawyer who drafted estate planning documents representing a party and also being asked to testify as to whether the testator had capacity to execute the document. They could also impact lawyers who work on matters with respect to closely held businesses.

D. In In re Waters[85], Elizabeth Waters' granddaughter, Claire Trent, challenged the will prepared by Waters leaving a life estate to Waters' cousin, Lillian Young, before the remainder was to go to Trent. The lawyer who represented Young in the will contest, Brian Murphy, was the

[84] Model Rule 1.7 deals with conflicts of interest and Model Rule 1.9 deals with duties to former clients.

[85] 647 A.2d 1091 (Del. 1994).

same lawyer who prepared Waters' will. As the lawyer who prepared Waters' will, Murphy was called to testify during the will contest regarding Waters' testamentary capacity. The Delaware Supreme Court found, relying on Rule 3.7, that "the centrality of Murphy's testimony to the contested issues of undue influence and testamentary capacity mandated his withdrawal as trial lawyer." The court found it was plain error for the Court of Chancery to permit Murphy to participate as a trial lawyer in a proceeding in which he was a central witness on the contested issue being adjudicated. The Delaware Supreme Court reversed the lower court and remanded the case for a new trial. The Supreme Court further directed the Clerk to send a copy of its opinion to the Office of Disciplinary Counsel.

XV. CONCLUSION

Representing clients in all phases of the life cycle of a closely held or family owned business can present many ethical challenges to any estate planning professional. However, with care and an understanding of the ethical rules, an estate planning professional can successfully navigate these challenges.

Hypotheticals

Hypothetical 1:

Karen Harris is advising a closely-held company on its conversion from a C corporation to an S corporation. The shareholders of the S corporation will be the two parents, their three children, and an irrevocable non-grantor trust which was created by mom's grandparents and which provides for discretionary distributions of income and principal to mom and her descendants. One of the three children is currently a citizen of Belize. Has Karen shown the requisite competence when she drafts the papers to make the S corporation election for the new company and lists the two parents, their three children, and the irrevocable non-grantor trust as shareholders? Will there be any adverse income tax consequences if the company qualifies for S corporation status? What steps may need to be taken to qualify the company for S corporation status?

Hypothetical 2:

Henry Barker is representing a closely-held corporation in a complicated transaction to purchase another closely-held corporation. Henry Barker is, as he would put it, somewhat of an amateur with respect to technology. One evening, Henry receives a copy of the latest response from the lawyers for the company that might be acquired. Henry, in order to broaden his knowledge, had recently read an article about the "metadata" that might accompany many electronic documents and which might allow the reader of a document to see what changes were made to the document, when those changes were made, and even what changes were made in an earlier version. What should Henry do with respect to the document that he has received if he discovers metadata on it? Should Henry check the document for metadata? May Henry check the document for any metadata, but not have to? Should Henry not check the document for metadata?

Hypothetical 3:

Lawyer Martha Snyder has been engaged by the three shareholders of a closely-held company to prepare a buy-sell agreement between the three shareholders to cover both departures during life and departures because of the death of one of the shareholders. The three shareholders believe that it is very important that the buy-sell agreement be completed as soon as possible in order to ensure that upon the departure of one of the shareholders, the other two shareholders have the opportunity to own all the stock in the company. One of the shareholders, Brian Rogers, is 67 years old. The other shareholders are younger.

While Martha works diligently on the buy-sell agreements, this is a new area to her, and it takes her some time to understand, for example, the difference between cross-purchase buy-sell agreements and entity purchase buy-sell agreements, as well as the rules that might apply if insurance on the lives of the shareholders is used to help fund the buy-sell agreement including how to avoid the “transfer for value” rules applicable to the taxability of insurance proceeds. Martha has been working to complete the buy-sell agreements for five months when she is informed, one morning that Brian Rogers, the 67 year old shareholder, has passed away while playing tennis. Since no buy-sell agreement is in place, it turns out that Brian’s will leaves the stock in the company to his eldest son, who is a bit of a dissolute, but who has already informed the other two shareholders that he looks forward to working at the company and being a co-owner with them. Has Martha violated her duty to provide competent representation in the preparation of the buy-sell agreement? Has Martha violated her duty to provide timely service in the preparation of the buy-sell agreement?

Hypothetical 4:

Five years ago, Lawyer Eric Jensen completed a buy-sell agreement for the ten members of the family that owned a large regional grocery chain. The buy-sell agreement provides that when a family member passes away, the family member’s stock will be purchased for set price of $20 per share. One member, Dennis Kroger, passed away three years ago with a substantial estate worth $50 million exclusive of the stock in the family’s grocery chain. Dennis owned 1,000,000 shares in the company on the date of his death and the company pays Dennis’ estate $20 million for the shares pursuant to the terms of the buy-sell agreement. Eric represents Dennis’ estate in the administration and the estate values the shares of the closely held stock at $20 million for federal estate tax purposes based on the price set in the buy-sell agreement. On audit, the IRS applies Section 2703 and says that the stock should be valued at its fair market value on the date of death which, after a lengthy audit and a Tax Court decision, is determined to be $50 million. As a result, $20 million in federal estate tax ($50 million x 40 percent tax rate) is owed by the estate while the estate receives only $20 million for the stock pursuant to the buy-sell agreement. Has Eric provided competent advice to the company and Dennis’ estate? If Eric previously represented Dennis in his estate planning, did Eric provide competent advice to Dennis in his estate planning? Does Eric have a conflict of interest in his representations of the company, Dennis in his estate planning, and Dennis’ estate?

Hypothetical 5:

Lawyer Judy Keller represents Dorothy Bruce, her son Frank, her daughter Jan, and various family businesses. With Judy’s assistance, Dorothy has executed a will that leaves the son her business interests when she passes away, and gives her daughter the remainder of her assets while stating that taxes, to the extent possible, should be apportioned against the non-business assets. Currently, the business interests are valued at $30 million and the remainder of Dorothy’s assets are valued at about $5 million. The will was executed with Frank in attendance, but Jan was not.

Judy subsequently does estate planning for Jan and never informs Jan of the provisions that mom has made in her estate plan. Jan is aware of a will that was prepared earlier in which mom left all of her assets equally to Frank and herself. In having Judy do her estate planning, Jan assumes Dorothy still plans to leave her assets equally between her brother and herself. Jan, in the course of the planning for the new will, asks Judy whether mom's will leaves everything equally to her and her brother and Judy tells her that it does. Has Judy violated any ethical duties in this representation of multiple family members? Does it make a difference if Judy did not represent Jan in Jan's estate planning?

Hypothetical 6:

John Anderson has represented a holding company that is owned by members of the Kendrick family. This holding company was created to take advantage of favorable treatment under the tax laws with respect to the different subsidiaries owned by the holding company. Several years after creating the holding company to facilitate the favorable tax treatment, the tax laws change with respect to the possible favorable tax treatment provided to the holding company if it ever sells one of the subsidiaries. Two years after the changes in the tax laws, the holding company, without consulting John, decides to sell a subsidiary and uses another law firm for the sale of the subsidiary. As a result, the holding company incurs far greater taxes than anticipated because of the change in the laws two years ago. The holding company sues John for failure to inform it about the changes in the tax. Has John violated any ethical duty to keep the client informed with respect to changes in the tax law? Is John liable for a failure to inform the holding company about the changes in the tax law?

Hypothetical 7:

Henrietta Jackson is the outside counsel for a closely-held business owned by three siblings. She has been the general counsel for the business for many years and works very well with each of the three siblings. The siblings, who currently comprise the board of directors of the closely-held company, have asked Henrietta to join its board of directors because of the wise and seasoned counsel that she would bring to it. Should Henrietta accept the offer to serve on the board of directors of the client? If Henrietta accepts the offer to serve on the client's board of directors, what special ethical considerations should Henrietta keep in mind?

Hypothetical 8:

Richard Slattery is a partner in a 150 lawyer firm in a mid-sized city in the Midwest. Richard has been asked by the chair of the board of a locally-based closely-held company to join its board of directors. Richard has a specialty in tax issues affecting both closely-held and publicly traded businesses and the board feels that it needs Richard's expertise as it enters what will be some challenging years for the company. Richard is delighted to receive the offer, but would like to explore how his presence on the board of directors would affect the business opportunities of this law firm. May Richard's firm represent the company if Richard serves on the board? May Richard's firm represent a party litigating against the company on whose board Richard is serving, as long as Richard recuses himself from participating in the matter both at the board level and at the law firm? Would it make a difference if the company was publicly traded?

Hypothetical 9:

Joanne Sullivan has been asked by her long time estate planning client, Dudley Henry (age 70), to assist in his estate planning. Dudley owns a series of businesses through corporations (both C corporations and S Corporations), limited liability companies, and limited partnerships. The accounting firm that handles the taxes for Dudley and the business interests has referred to the business interests as a confusing and contradictory maze or hodge-podge. Dudley wants to see what he can do about consolidating those business interests. He also wants to engage in estate planning to reduce the exposure of his estate to estate tax. Dudley asked Joanne what sort of steps could be taken. After much review of possible estate planning strategies with Joanne, Dudley determines that he would like to set up a series of limited partnerships in which he, his wife, and his adult children will be members. Dudley and his wife will make gifts of limited partnership interests to the children.

Dudley wants Joanne to represent the entities in the formation of the limited partnerships and also to advise his children on their rights and responsibilities as partners in the limited partnerships. Dudley does not want the children to have separate counsel because he thinks that this would be too expensive, especially since this is a simple transaction and the relationships between his wife and him and his four children are quite good. Two of the children work in the business and two children do not. May Joanne represent Dudley, his wife, the new entities, and the children in the creation of the new entities without violating the rules with respect to conflicts of interest? Would it make a difference if Dudley is currently married to his third wife and two of his four children are from his marriage to his first wife and two of his four children are from his marriage to his second wife? Would it make a difference if his current wife is currently pregnant with what will be Dudley's fifth child, who will be, when born, 30 years younger than Dudley's current youngest child?

Joanne represents the current entities and the new limited partnerships in their creation as part of the planning for Dudley. When Joanne represents the limited partnerships, exactly who is Joanne representing? Does Joanne represent the partnerships which are separate entities from their partners? Does Joanne represent each of the individual partners because the partnerships have no separate entity status? Does Joanne represent the partnerships as entities and by extension each of the partners?

Hypothetical 10:

Morgan Markus' law firm became involved with a family in connection with litigation over a commercial building owned by the patriarch of the family. During the litigation, questions about the patriarch's capacity arose and because the patriarch's had not done any estate planning, the firm instituted a proceeding for the appointment of a guardian to represent the financial interests of the patriarch. The firm then prepared an estate planning memorandum recommending that the commercial building be placed in a family limited partnership.

Two of the patriarch’s three children looked solely to Morgan and his firm for advice. The third child, however, consulted with independent counsel. All three children retained Morgan to draft the partnership agreement and form the entity. The three children were general partners. One child, Godiva hires separate counsel. At the insistence of Godiva’s, separate counsel, a unanimous consent provision was included in the partnership agreement so that any one general partner could deadlock the partnership.

After the formation of the partnership, Morgan continued as general counsel to the partnership and represented all three siblings on family matters. Morgan also advised the two other siblings as general partners and on individual matters.

Disputes then arose among the sibling partners regarding the redevelopment of the commercial building and leasing of space in the commercial building and the partners became deadlocked. The other two siblings wished to grant one of the lessees of building the right to sublet and manage the property which would decrease the management power that Godiva was able to exercise due to the unanimous consent provisions in the partnership agreement. Questions arose about the work being done by Morgan when Godiva looked at the bills. Godiva requested access to all of Morgan’s firm’s files on the partnership. Should the firm provide Godiva with access to the files?

Hypothetical 11:

Law firm partner, John Mason, requested an associate to research what factors should be taken into account in determining whether a lawyer-client relationship had been formed between corporate counsel and its constituents. What factors should the associate discuss with respect to whether a relationship has been developed between a corporation and its constituents? The associate, in doing so, will take account of Model Rule 1.13(f) which deals with the potential conflict and states:

> In dealing with an organization’s directors, officers, employees, members, shareholders or other constituents, the lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization’s interests are adverse to those of the constituents with whom the lawyer is dealing.

Hypothetical 12:

Rachel Sanderson represents a closely-held construction contractor in its various business dealings. In the course of the representation of the closely-held contractor, Rachel is impressed by the quality of the contractor’s construction work. Rachel and her husband decide to hire the contractor to build their home. After entering into the contract, Rachel and her husband are subsequently dismayed by the quality of the work that was done and find numerous problems with the work. They institute litigation against the contractor alleging breach of contract with respect to the construction of their house.

In entering into the contract with the contractor and bringing the action against the contractor client, has Rachel violated the provisions of Model Rule 1.8 which contains a stringent standard for business transactions between lawyers and their clients?

Hypothetical 13:

Thomas Holson represents ABC Company, a manufacturer of imprinted t-shirts and other garments. The closely-held company is doing well, but the current owners are getting older and would like to sell the business. Thomas has advised the owners for many years and the owners trust Thomas' judgment as he has helped them through many difficult situations. Thomas also represents a small company in the area which is looking to acquire businesses as part of a plan of diversification. Thomas has been advising this other business on the diversification efforts. Thomas, with the permission of the owners of the t-shirt company, informs the other client, which is seeking to diversify, that the t-shirt company might be interested in being acquired. With the consent of all the parties, may Thomas represent both the t-shirt company and the other company in the sale of the t-shirt company to the other company? Suppose in this fact situation that Thomas' representation of the t-shirt company had ended five years ago and that he still represents the other company. May Thomas represent the other company in its acquisition of the t-shirt company or does this run afoul of Model Rule 1.9 with respect to duties owed to former clients?

Hypothetical 14:

Tina Zachary has been representing a closely-held business for many years. She had worked very well with the mother and father who owned the business. However the mother and father have both died, the administration of their estates is complete, and one of the children is running the business. The child became upset with Tina because he feels that Tina had improperly advised his parents on giving the liquid portion of their substantial estate to charity when they died rather than leaving the entire estate to the three children. As a result, the child terminated Tina's representation of the company a year and one-half ago. However, the company has not paid Tina's firm the fees owed for the work Tina did for the company for over one year prior to the termination of the representation. As part of terminating the relationship, the child who is now running the company, sends a standard letter to Tina's law firm requesting that all files be transferred. Can Tina's firm withhold the files until the firm's fees are paid or must Tina's firm transfer the files to the former client? Suppose Tina's firm says that it wants to assert a lien over the files because the firm has not been paid? This type of lien is sometimes called a "retaining lien".

Hypothetical 15:

Rosemary Baker is representing one of the three owners of a closely-held business in its liquidation which is occurring because that owner exercised a clause in the corporate documents that permits one of the three owners to terminate the business at any time and for any reason. The other two owners have yet to get counsel to represent them in the liquidation of the business. There will be several tricky issues that will need to be resolved in order to successfully liquidate the business. Rosemary did participate in a meeting at which her client presented her client's plan for the liquidation to the other two owners who did not have counsel at the meeting, What steps should Rosemary take in this situation under Model Rule 4.3 with respect to dealing with unrepresented persons?

Hypothetical 16:

Linus Brown owns a closely-held company and has a majority of the shares. Wright Morris has been Linus' counsel for many years both in representing the company and in advising Linus on his estate planning. Linus' children, who hold minority interests in the corporation, are coming of age and Linus would like Wright to do estate planning for each of the children partly to insure that ownership of the company stays within the family and does not pass to spouses of the children. May Wright do estate planning for each of the children? If Wright concludes that he can do the estate planning for each of the children, does it make a difference if the children live in states in which Wright does not reside and is not licensed to practice? Can Wright, if he decides that he can represent the children in their estate planning, meet the requirements of Model Rule 5.5 with respect to representing clients in a jurisdiction who reside outside a jurisdiction in which the lawyer is licensed? Would it make any difference if Wright believes that he will only be advising on matters of federal law? Does Wright face any conflicts issues under Model Rule 1.7?

Hypothetical 17:

Two years ago, Lawyer Lewis Wesson represented a closely held business in the reorganization of the business to divide the responsibility for running the company between the 70-year old matriarch, Judy, and her daughter, Sarah. Judy is a widow. At her husband's death, Judy became chair of the board while Sarah became the CEO. Judy owns 51 percent of the stock in the company and Sarah and her two siblings own the remaining 49 percent of the stock. All of the stock is voting stock. Since the reorganization of the business, Lewis has heard rumors of disagreements between Judy and Sarah on the future course of the business. This morning, Judy called Lewis and told Lewis to prepare the necessary papers to terminate Sarah immediately. Judy said that Sarah had come under the influence of drugs and called her a "hippie reincarnate." Judy also said that Sarah was listening to her husband, Rick, on business decisions and Rick lacked the sense that God gave billy goats. Rick is an independent business consultant who started at McKinsey Consulting and has been quite successful since striking out on his own.

Immediately after hanging up the telephone from the call with Judy, Sarah calls Lewis and says that she thinks that her mother is losing her mind. Judy does not always recognize Sarah when Sarah calls or visits and confuses Sarah with her sister, Susan, who does not work for the company but instead teaches at a university on the West Coast. In addition, Judy has taken up with a 30-year old hairdresser whom she takes to parties and introduces as her fiancé. Recently, Judy and the hairdresser took a two week trip to a Sandals resort in Jamaica about which Sarah just recently learned. Two days ago, Judy brought the hairdresser to the quarterly board meeting and the hairdresser spoke up often during the meeting and criticized Sarah's management. During the call, Sarah seems somewhat frantic and disoriented to Lewis.

Immediately after hanging up with Sarah, Rick calls Lewis. Rick tells Lewis that he is calling because Lewis did the estate planning for Sarah and him last year and he does not know to whom else to turn. Rick says that Sarah has recently been quite depressed and has been drinking a lot. In fact, Rick wants to use the medical power of attorney that Lewis drafted for Sarah and which names Rick as agent to involuntarily send Sarah to the Hazelden Clinic for a month. Rick wants Lewis' advice on what he should do. He also asks Lewis about who will run the company in Sarah's absence.

What should Lewis do in this situation in responding to the three telephone calls?

Subsequently, litigation breaks out between Judy, Sarah, and Rick. Lewis is called as a witness by the lawyers for each of Judy, Sarah, and Rick. What ethical considerations should Lewis take into account in acting as a witness?

Hypothetical 18:

Bill Morris is a business lawyer at a mid-size firm who also does some estate planning. He represents a large number of closely held businesses and has developed a reputation statewide for dealing with ESOPs. His firm bases compensation to its partners on an "eat what you kill" approach. One day, Bill's friend, Jimmy Self, makes a business proposal to Bill. Bill is an agent for a large financial services company whose ratings for its insurance products are marginal. Jimmy proposes an arrangement in which Bill will introduce executive insurance, and deferred compensation, disability, and retirement products provided by Jimmy's financial services company to his business clients. For each client that signs up, Jimmy's company will pay a referral fee to Bill's firm based on the value of the products that each client signs up for. In addition, Bill will likely get the legal work to implement the new benefits from each client that signs up. Can Bill entered into this arrangement with Jimmy and his company? Should Bill enter into this arrangement with Jimmy and his company?

Hypothetical 19:

Carson Land is the lawyer for a highly successful closely held technology company that has put itself in play. Carson has been involved in all of the planning for this including setting the minimum price at which the owners will agree to sell the company. The company is negotiating with a potential purchaser at a price two times the minimum. The company wants to get the deal finalized by the end of the year. In fact, the parties are negotiating at Carson's firm on December 22 while the firm's Christmas party is being held in the conference room next door. Carson, one of the owners of his client, and the lawyers representing the purchaser take a break and go next door to the Christmas party. The lawyers for the purchaser have a fair amount of the senior partner's Holiday Punch which packs a lot of punch. Carson and the owner of his client know better and merely sip a small amount of the lethal punch.   Carson, the owner of his client, and the lawyers for the purchaser reconvene after spending about an hour at the party at which point the lawyers for the purchaser open by offering a price three times the minimum price at which the owners would have agreed to sell the company and about double that amount that the parties had previously been discussing. What should Carson do in this situation? Does it make a difference that one of the owners is present and, without consulting Carson, immediately says yes to the new price?

Hypothetical 20:

Lawyer John Rake is a business lawyer with an entrepreneurial streak. He has been highly successful in investing in several distressed businesses when he has been able to secure enough control to make the changes that he believes are necessary to make the businesses a success. Recently, the owner of one of Rake's clients, which is facing a severe cash-flow problem, has been discussing possible steps with Rake. Rake, sensing an opportunity and seeing the potential, says that he, through one of his personal entities, will provided sufficient funding to the distressed client to relieve the current cash-flow problem and provide breathing room. In return, the client must accept certain conditions and changes in the operations that Rake will require. Rake draws up the agreement with the client to implement the financing and the client signs without representation by another lawyer. Has Rake violated any ethical obligations to the client? What steps should Rake take to meet his ethical obligations?